M&A in Canada

A Legal Overview

M&A Activity in Canada is a guide to the legal issues involved in the acquisition of a Canadian business, whether public or private, friendly or hostile.

This publication will be of value to our clients and their board members, to their in-house legal teams, and to U.S., U.K. and foreign counsel. This publication has been written in a straightforward and easy-to-follow format by members of Stikeman Elliott's M&A Practice Group.
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Introduction

As a stable, resource-rich country with a robust and diversified economy, Canada is a leading destination for foreign investment from all over the world. *M&A in Canada* is a guide to the important and distinctive features of Canadian law as it relates to M&A. It considers the perspectives of both acquiror and target and reviews the law as it affects both public and private companies, including the duties and obligations of their directors and officers and the processes involved in unsolicited bids and negotiated transactions.

Canada and its provinces

Investors in Canada generally find that provincial regulators (those whose authority derives from the country’s ten provinces) figure more prominently in M&A transactions than do state-level regulators in the U.S. That is partly because, under the Canadian constitution, Canada’s provincial governments have jurisdiction over property and civil rights within their respective territories. This area of jurisdiction encompasses much of the legal subject matter of M&A transactions, including contract law, real estate law, labour and employment – although in certain cases the federal government may exercise authority in these areas (e.g. with respect to interprovincial undertakings or federally-regulated industries such as banking and telecommunications).

Securities regulation is perhaps the most striking example of a provincial power in Canada. While most industrialized countries have national securities legislation and a national regulator (such as the U.S. Securities and Exchange Commission), Canadian securities law involves thirteen statutory and regulatory regimes with thirteen distinct regulators – one for each of the ten provinces and three territories of Canada. The statutory and regulatory regimes that are in force in these thirteen jurisdictions are generally similar (and, thanks to co-operative efforts, are becoming more alike with time), but there are enough differences to make compliance a matter of some complexity in many cases.

Staying Informed

For a general overview of Canadian business law, please refer to our publication *Doing Business in Canada*, available from your usual Stikeman Elliott contact or through our website, www.stikeman.com. On that site you will also find, via our “Knowledge Hub”, links to the firm’s blogs on M&A issues, securities law, competition law, employment law and other areas of law that may be of interest to you.
Disclaimer

This guide is intended for general informational purposes only and is distributed on the understanding that it is not a comprehensive statement of the law of any jurisdiction. It does not constitute legal advice and must not be used as a substitute for obtaining such advice from qualified counsel. Statements and analyses in this guide are of a broad and general nature only and may differ from positions taken by the firm or its members in specific situations.

This guide is based primarily on federal and Ontario law as of July 1, 2017. While the laws and regulations applying in other Canadian jurisdictions are frequently similar to those of Ontario, there are also many significant differences, only some of which are described in this guide. Please note that the distribution of this guide, or any part of it, to any entity or person does not contribute to the creation, continuation or revival of a lawyer-client relationship with Stikeman Elliott LLP, its related entities (including the Stikeman Elliott practices in the U.S., U.K. and Australia), or any other entity or person.
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M&A in Canada: Competition and Foreign Investment Law

Introduction

In this discussion, we focus on two areas of regulation that can be key to cross-border M&A: competition law (as antitrust is known in Canada) and foreign investment review. While other areas of regulation, such as employment and labour law, often have significant effects on M&A transactions, competition and foreign investment law are two of the main channels through which federal government policy on acquisitions and foreign ownership is directly expressed.

Note that recent developments in Canadian competition and foreign investment law are reported and analyzed by Stikeman Elliott’s blog, The Competitor (www.thecompetitor.ca). The site includes resource materials and links to relevant government websites.

Competition / Antitrust

The basics: the Competition Act, the Commissioner and the Tribunal

In contrast with many other areas of regulation in Canada, competition and foreign investment review are, for virtually all intents and purposes, federal matters only. Competition law – the subject of the first half of this discussion – is governed by the Competition Act, which Parliament passed in 1986. The Act is administered by the office of the Commissioner of Competition, whose responsibilities include the investigation of mergers and anti-competitive business practices. On the application of the Commissioner of Competition (or, in certain circumstances, of private parties), a quasi-judicial body called the Competition Tribunal may conduct hearings on merger review, the regulation of “dominant” firms, refusal to deal, exclusive dealing, tied selling, market restriction or misleading advertising.

Successive Canadian governments have grown increasingly attentive to the anti-competitive effects of mergers and other business practices. In 2009, Parliament enacted the most significant amendments to date to Canada’s competition regime, creating (among other things) the new U.S.-style “two-stage” merger review process. Before we come to that, it will help to review the standards of merger review and the advance notification requirements.
Standards of merger review

Definition of “merger”

Section 91 of the Competition Act defines “merger” very broadly:

... the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or a part of a business of a competitor, supplier, customer or other person.

What constitutes an acquisition of "control" is set out in the Competition Act and includes the acquisition of a majority voting interest in an entity (whether in a corporate or another form). "Significant interest" is not defined, but the Commissioner has issued interpretive guidelines.

It makes no difference whether the merger happens by purchase of shares or lease of assets, by amalgamation or combination, or otherwise. The Commissioner of Competition is entitled to challenge an acquisition before the Tribunal at any time up to one year after its completion, unless an Advance Ruling Certificate (ARC) has been granted (see below). Where the Tribunal determines that competition in a market has been or will be prevented or lessened substantially as the result of a merger or proposed merger, it may exercise its broad discretionary authority to make a remedial order. Such an order can include the outright prohibition of a proposed merger or, in the case of a completed merger, the requirement to divest all or part of the acquired business.

The principal substantive test

For mergers, the principal substantive test under the Competition Act is whether a merger “would or would be likely to prevent or lessen competition substantially” in a relevant market. This is the test that the Commissioner of Competition uses when deciding whether to initiate an application to the Tribunal and it is also the test that the Tribunal uses in its adjudication of an application. In applying the test, the Commissioner of Competition and the Tribunal will consider the extent and effectiveness of foreign competition, whether the business of a party to the merger has failed or is likely to fail, the extent and availability of acceptable substitutes for products supplied by the parties, current barriers to entry into the market, whether the transaction would result in the removal of a vigorous and effective competitor, the extent to which effective competition would remain following the transaction and the nature and extent of change and innovation in the relevant market.

Merger Enforcement Guidelines

The analytical framework that has been adopted by the Commissioner of Competition employs legal and economic criteria similar to those found in U.S.
antitrust jurisprudence. In October 2011, the Commissioner of Competition re-released the *Merger Enforcement Guidelines*, modelled on similar guidelines adopted by the U.S. Department of Justice, which set out in general terms how the merger review provisions of the *Competition Act* are to be administered.

**Advance notification of large transactions**

**General**

Certain large transactions trigger advance notice requirements under the *Competition Act*. Such transactions cannot then be completed until the end of the review period discussed below (the so-called “waiting period”). Pre-merger notification filings are required in connection with a 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 parties,” the ”size of the transaction” and ”shareholding” are exceeded. In January 2012, the Commissioner of Competition re-released *Merger Review Process Guidelines* (MRGs), which describe the general approach to administering the two-stage merger review process applicable to proposed transactions that are the subject of a pre-merger notification filing requirement.

**What counts as a “large transaction”?**

If the parties to a transaction, together with their respective affiliates, have total assets in Canada exceeding $400 million or total gross annual revenues from sales in, from or into Canada exceeding $400 million (the “size of parties” threshold), the Commissioner of Competition must be notified of any of the following.

- An acquisition of assets in Canada, with a book value in excess of $87 million or which generate gross revenues from sales in or from Canada of more than $87 million.
- The formation of an unincorporated business combination where the value of the assets in Canada contributed, or the gross revenue from sales in or from Canada generated from those assets, exceeds $87 million.
- An amalgamation where at least two of the amalgamating corporations (including their respective affiliates) have assets in Canada with a value exceeding $87 million or have gross annual revenues from sales in or from Canada in excess of $87 million and the value of the assets in Canada of the continuing corporation or the gross revenues from sales in or from Canada generated from those assets exceeds $87 million (while the *Competition Act* does not provide a definition of “amalgamation”, the Competition Bureau has stated that the union of two or more corporations, whereby they become one corporation, pursuant to valid legislation is considered an amalgamation for purposes of the *Competition Act*, whether the amalgamation occurs under federal or provincial legislation or under the laws of a foreign jurisdiction).
- An acquisition of an interest in an unincorporated business combination (e.g. a partnership) that carries on an operating business with assets in Canada, or
gross revenues from sales in or from Canada generated from those assets, in excess of $87 million.

- An acquisition of voting shares of a corporation which, together with all other corporations controlled by it, has assets in Canada, or annual gross revenues from sales in or from Canada generated from those assets, in excess of $87 million.

Each of the above pre-merger notification preconditions is commonly known as the “size of the transaction” threshold. The threshold ($87 million in 2016) is indexed annually to nominal GDP growth.

With respect to the last two circumstances in the list above, it should be noted that notification of an acquisition of an interest in a combination or of voting shares of a corporation will be required only if certain “interest” or “shareholding” thresholds would also be exceeded. These thresholds differ depending on whether the transaction is a combination or share acquisition. In the case of a combination, the thresholds are:

- A right to more than 35% of the profits or the assets on dissolution; or
- Where this threshold has already been exceeded, a right to more than 50% of the profits or assets on dissolution.

In the case of the acquisition of the voting shares of a corporation, the thresholds are:

- More than 20%, in the case of the acquisition of voting shares of a public company.
- More than 35%, in the case of the acquisition of voting shares of a private company.
- More than 50%, in the case of a subsequent acquisition of voting shares of either kind of company by a person that has previously surpassed the threshold set out above with respect to that company.

With the exception of a proposed corporate amalgamation (which requires that at least two of the amalgamating entities have a presence in Canada) it is possible for the target entity to exceed both the size of parties and size of transaction thresholds on its own.

**Filing obligations**

Where a transaction is notifiable, the parties may file a pre-merger notification pursuant to the *Notifiable Transactions Regulations*. Generally, a pre-merger notification requires information such as a description of the proposed transaction and business objectives intended to be achieved by it; a list of foreign authorities that have been notified of the proposed transaction and the dates on which they were notified; and various information in respect of each party and its affiliates, including a description of its principal business and principal categories of products, and detailed customer and supplier information.

Pre-merger notification filings are subject to a filing fee of $50,000.
The two-stage merger review process

An initial 30-day waiting period will apply following the submission of a pre-merger notification filing, during which time the proposed transaction cannot be completed (unless earlier termination has been granted). If during this 30-day period, the Commissioner of Competition issues a "supplementary information request" (SIR), it will effectively reset the clock and a new 30-day waiting period will commence following compliance with the SIR.

Where the Commissioner of Competition determines that a SIR is necessary, parties will be notified within the initial 30-day waiting period that a SIR is forthcoming, and will generally be provided a draft of the SIR in advance of issuance. The MRGs encourage the use of pre-issuance dialogue to assist in clarifying the draft SIR for the parties, as well as to assist the Commissioner of Competition in understanding the forms of information available and any factors that might impair the ability of the parties to comply. Once the SIR is issued, the MRGs describe a post-issuance dialogue process for prioritizing the information requests, discussing the process for identifying custodians and conducting electronic searches, and where information is provided on a rolling basis, confirming whether further information is required.

Where a party has completed a proposed transaction before the expiry of the waiting period, either a court or the Competition Tribunal, on application by the Commissioner of Competition, may impose a fine of up to $10,000 per day of non-compliance with the waiting period, in addition to other penalties.

Dual filing for transportation undertakings

Under the *Canada Transportation Act*, when a pre-merger notification is required to be filed under the *Competition Act*, parties to a proposed merger transaction involving a "transportation undertaking" must also give notice to the Minister of Transport, Infrastructure and Communities. Failure to notify the Minister when required is a criminal offence punishable by fine up to a maximum of $50,000.

Where the dual-notification requirement applies, notice to the Minister is to contain the same information as provided to the Commissioner of Competition under the *Competition Act* (i.e., the information prescribed under the *Notifiable Transactions Regulations*), as well as information on the public interest as it relates to national transportation, as required by non-statutory guidelines to be issued by the Minister. Once a filing has been made to the Minister, the Minister has 42 days to decide whether the proposed merger raises any public interest issues. Until final guidelines are issued, there is uncertainty as to the criteria that the Minister will use to make such a determination. If the Minister is of the opinion that public interest

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1 Prior to amendments in 2007, notice was limited to transactions involving air transportation undertakings. Foreign ownership restrictions applicable to the air transportation sector continue to apply, but they have not been extended to non-air transportation undertakings.

2 On July 28, 2008, Transport Canada released draft Guidelines for Mergers & Acquisitions involving Transportation Undertakings. Final guidelines have yet to be published.
issues are raised, the parties will not be permitted to close the transaction without the approval of the Governor in Council (i.e., effectively the federal Cabinet), which will ultimately depend on the Minister’s recommendation and undertakings agreed to by the parties. If the parties implement a transaction without such approval, the Minister may apply to a superior court to make any appropriate remedial order, including a divestiture of assets. Note that the Canada Transportation Agency is of the view that the issuance of an advance ruling certificate or s. 113(c) waiver (which exempts parties from the Competition Act notification obligation) does not exempt parties from the CTA notification obligation.

**Advance ruling certificates (ARCs)**

The Act establishes an advance ruling process through which parties to a proposed merger transaction may seek an ARC from the Commissioner of Competition confirming that, on the basis of a review of the facts they have represented in their application, the Commissioner of Competition will not challenge the proposed merger. An ARC has two advantages. First, it exempts the parties from the statutory requirement to notify the transaction or terminates the statutory waiting period. Second, it prevents the Commissioner of Competition from challenging the proposed transaction following its completion.

All requests for an ARC are subject to a filing fee of $50,000. When both a pre-merger notification filing and an ARC request are filed in respect of the same transaction, only the fee for an ARC request applies.

An ARC will be issued only in the clearest of circumstances where the Commissioner of Competition is of the view that a transaction will not or will not be likely to substantially lessen or prevent competition in any relevant market. However, if the request for an ARC is denied, the Commissioner of Competition may issue a letter stating that she has no current intention to challenge the transaction (a so-called “no-action” letter). Parties will regularly close their transactions on the basis of an unqualified “no-action” letter. For all intents and purposes, the only technical distinction between the issuance of an ARC and a “no-action” letter is that in the case of a “no-action” letter, the Commissioner of Competition retains his right to challenge the transaction within one year of closing. Having said that, we are not aware of any instance where a post-closing merger challenge occurred, following the issuance by the Commissioner of Competition of an unqualified “no-action” letter. The other notable distinction between an ARC and a “no action” letter from a procedural perspective is that the issuance of a “no-action” letter does not automatically exempt parties from the pre-merger notification obligation. However, the Commissioner of Competition may (and routinely will) waive the obligation to notify a transaction if substantially similar information as that required in a notification filing was provided in the ARC request.
Foreign Investment Review Considerations

The *Investment Canada Act* (ICA) allows the federal government to screen proposed foreign investments to ensure that they are likely to produce a “net benefit to Canada.” In March 2009, the ICA was amended in several respects, most notably by raising thresholds for review of direct acquisitions (which came into effect in April 2015) and by introducing a new national security review provision.

Under the ICA, certain types of transactions are exempt, while others are subject to review and still others are subject only to a post-closing notification requirement.

**Exempt transaction types**

Exempt from the investment review provisions of the ICA are certain transactions involving:

- Securities dealers and venture capitalists acting in the ordinary course;
- Tax-exempt vendors;
- Banks;
- The acquisition of government-owned or government-controlled businesses;
- Involuntary acquisitions (through inheritance or by operation of law);
- The temporary acquisition of a business in connection with the facilitation of financing arrangements;
- The acquisition of a business in connection with the realization of security in limited circumstances;
- Corporate reorganizations where the ultimate direct or indirect control remains unchanged;
- The acquisition of a business the revenue of which is generated from farming carried out on real property acquired in the same transaction; or
- Certain investments by specified insurance companies.

It should be noted that the national security review provisions still apply to a transaction falling under one of these exemptions and other legislation might also apply.

**Reviewable transactions**

**General**

The ICA generally requires every “non-Canadian” investor (other than investors ultimately controlled in countries belonging to NAFTA or the World Trade Organization (WTO)) who acquires control of a “Canadian business” to file an application with the Minister of Innovation, Science and Economic Development prior to making an investment if either of the following is the case:

- The investor proposes a direct acquisition of a Canadian business with assets with a book value of $5 million or more; or
The investor proposes an indirect acquisition of a Canadian business (i.e., an acquisition of a Canadian business through the acquisition of shares of a corporation incorporated outside of Canada) if the book value of its assets is valued at over $50 million and the Canadian assets acquired represent more than half of the assets acquired in the total transaction.

It should be noted that an indirect acquisition of a Canadian business with assets valued in excess of $50 million (subject to WTO investor rules) is subject to review (even where the assets of the Canadian business represent less than 50% of the value of the assets acquired in the total transaction), but the application in respect of such an acquisition may be filed up to 30 days following closing.

Current standards for WTO Investors

“WTO investors” (those investors ultimately controlled in a WTO member country), including American and most European investors, have been given substantially more freedom to invest in Canada. In addition, the ICA provisions relating to the acquisition of a Canadian business under the control of a (non-Canadian) WTO investor by an investor from a third country make it significantly easier for WTO investors to sell their Canadian businesses. Direct acquisitions of Canadian businesses by a WTO investor or an acquisition of a Canadian business from a person who is controlled in a WTO country (other than Canada) will be reviewable if the “enterprise value” of the Canadian business being acquired, calculated using the method prescribed in the regulations, exceeds $600 million, unless the Canadian business is engaged in cultural activities (see discussion below). Under the ICA, the $600 million enterprise value threshold will increase to $800 million in 2017 and $1 billion in 2019 and will be indexed to annual GDP growth from 2021 onward. In addition, legislation currently before Canadian parliament would increase the enterprise value threshold to C$1.5 billion for entities ultimately controlled in jurisdictions with which Canada has a free trade agreement (including, namely, the U.S., Mexico and European Union countries).

Indirect acquisitions by WTO investors are not reviewable unless the Canadian business is engaged in cultural activities, as described below.

Exceptions relating to cultural activities

Notwithstanding the higher thresholds set out above, the general thresholds discussed above apply even to WTO investors if the Canadian business is a “cultural business”.

A “cultural business” is a business that does any of the following:

- Publishes, distributes or sells books, magazines, periodicals, newspapers or music in print or in machine-readable form, unless all that it does is to print or typeset books, magazines, periodicals or newspapers;
- Produces, distributes, sells or exhibits audio, film, video or music-video recordings; or
Broadcasts through the media of radio, television or cable television, provides satellite programming or broadcast network services, or engages in radio communication, other than broadcasting, in which the transmissions are intended for direct reception by the general public.

A proposed acquisition involving a Canadian “cultural business” is reviewed by the Minister of Canadian Heritage and is assessed against specific cultural business policies of the Department of Canadian Heritage. In certain circumstances an acquisition may be prohibited based on current cultural business policies (e.g., foreign acquisitions of Canadian-owned periodical publishing businesses are prohibited).

Where a proposed acquisition involves both a cultural and a non-cultural business, both the Minister of Canadian Heritage and the Minister of Innovation, Science and Economic Development will have jurisdiction.

When is there an “acquisition of control” of a Canadian business?

The ICA provisions apply only to acquisitions of “control” of a Canadian business, whether it is a corporation, trust, partnership, etc. The ICA contains detailed rules for determining when control of an existing business has been acquired by a non-Canadian.

The Canadian business of a corporation doing business in Canada might be acquired through a (direct or indirect) share purchase or an asset purchase. Similarly, for entities that are not corporations (e.g. partnerships), an acquisition may occur by way of an acquisition of voting interests or assets. While the ICA allows for Ministerial discretion with respect to characterizing specific transactions, the basic rule is that any transaction in which a non-Canadian acquires the majority of voting shares/interests of a Canadian business is considered an acquisition of control of that Canadian business. There is also a presumption that an acquisition of one-third to one-half of the voting shares of a Canadian business is an acquisition of control (this presumption may be rebutted by demonstrating that there is no control in fact). The acquisition of less than one-third of the voting shares is generally not considered an acquisition of control. The one possible exception is with respect to a cultural business whereby, notwithstanding that less than one-third of the voting shares/interests are being acquired, the Minister can decide on the facts whether control has been acquired. The acquisition of all or substantially all of an entity’s assets is also considered an acquisition of control. This is subject to a general provision, applicable to corporations and non-corporations, that one cannot preclude the application of the ICA by structuring an acquisition as many small transactions each of which falls below the thresholds under discussion here. Such multiple transactions will be treated as one transaction even in cases where they are demonstrably unrelated to one another.
Ministerial approval

Except as noted below, an investment for which there is a requirement to file an application for review cannot be completed until the Minister has, or is deemed to have, issued the net-benefit-to-Canada ruling. Once the Minister has received an application for approval of a proposed transaction, a notice must be sent to the applicant within 45 days advising that the Minister is, or is not, satisfied that the investment will be of net benefit to Canada. If the Minister is unable to make this determination within 45 days, the Minister may extend the period by 30 days (or longer if the investor agrees). If the Minister fails to send a notice in the prescribed time, he or she is deemed to be satisfied that the investment will be of net benefit to Canada.

There are exceptions to the general rule that an investment subject to review cannot be completed until the Minister has, or is deemed to have, issued a net benefit ruling:

- Where the Minister is satisfied that delaying the implementation of the investment until the completion of the review would result in undue hardship to the non-Canadian or would jeopardize the operations of the subject Canadian business;
- An indirect acquisition (i.e. the acquisition of a Canadian business through the acquisition of a corporation incorporated elsewhere than Canada); or
- An acquisition of a business involved in an activity appearing on a prescribed list of activities related to Canada’s cultural heritage or national identity, where the federal Cabinet has decided that it is in the public interest to review the acquisition even though it is below the threshold at which review would otherwise take place.

In the case of these types of investments, the review could take place after the completion of the investment, and the investments would remain subject to the net-benefit-to-Canada standard. Where a transaction is not determined to be of net benefit to Canada, it will not be approved.

Finally, it is very common for the Minister to require investors to provide legally binding undertakings as a condition to receiving a net-benefit-to-Canada ruling. These undertakings, which will vary from transaction to transaction in light of the particular facts, may include commitments to maintain employment levels in Canada, to appoint a certain member of Canadians to board positions or senior management, and to make minimum capital expenditures in Canada.

When is an investment “likely to be of net benefit to Canada”?

In order for an investment to be found “likely to be of net benefit to Canada,” it need only be demonstrated that, on balance, it is likely to produce some net benefit to Canada. In making this determination, the Minister will take into account the following:

- The effect of the investment on the level and nature of economic activity in Canada;
• The degree and significance of participation by Canadians in the Canadian business and the relevant Canadian industry;
• The effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;
• The effect of the investment on competition within any industry in Canada;
• The compatibility of the investment with national industrial, economic and cultural policies; and
• The effect of the investment on Canada’s ability to compete in world markets.

The Minister will consult with all provincial governments likely to be affected by the proposed investment. Additionally, the Minister will consult with other federal departments that may have experience or general authority over the matters which factor into the net benefit ruling (e.g. the Competition Bureau, the Canadian Transportation Agency, or the Canadian Radio-television and Telecommunications Commission). Generally speaking, the Minister will not sign the net benefit ruling without first taking into account input from the relevant federal departments or agencies and provinces.

**Investments by foreign state-owned enterprises (SOEs)**

Another exception to the higher threshold is investments by foreign SOEs. A direct acquisition of control of a Canadian business by a WTO investor who is an SOE is reviewable if the book value of the assets of the Canadian business to be acquired is more than $375 million in 2016 (indexed annually to nominal GDP growth).

The definition of an SOE is very broad under the ICA. SOEs include governments of foreign states, entities directly or indirectly controlled or influenced by those states, as well as individuals acting under the direction or direct or indirect influence of a foreign government or agency. The Minister of Innovation, Science and Economic Development also has the discretion to determine that a minority acquisition by a SOE investor may constitute an acquisition of control. The new notification forms introduced in 2015 seek more information intended to assess the extent of SOE control, direction or influence.

In 2007, the Government of Canada issued “Investments by state-owned enterprises — Net benefit assessment” (the Guidelines). In addition to the factors that the Minister typically considers in deciding whether to approve reviewable investments (e.g., the impact of the transaction on employment, capital expenditures, Canadian participation in senior management), the Guidelines identify the “governance and commercial orientation of state-owned enterprises” as central considerations in reviewing SOE investments.

The Guidelines state that the Minister will assess the SOE’s adherence to Canadian standards of corporate governance, such as commitments to transparency and disclosure, independent directors, audit committees and equitable treatment of shareholders, as well as compliance with Canadian laws and practices. The
Minister will also consider how and to what extent the investor is owned or controlled by a state. For example, how (if at all) is the state directly involved in the operation of the SOE?

In addition, the Minister will scrutinize the commercial orientation of the SOE in relation to its prospective operation of the target business, in particular, regarding: “where to export; where to process; the participation of Canadians in its operations in Canada and elsewhere; the support of on-going innovation, research and development; and the appropriate level of capital expenditures to maintain the Canadian business in a globally competitive position”. A central concern of the Government is that foreign states do not buy up “strategic resources” such that they are in a controlling market position or do not supply Canadian customers but simply funnel the resources to the home country. The Government may also be concerned about the non-exploitation of resources such that the proposed investment would reduce the level of economic activity in Canada.

Finally, the Guidelines outline the types of binding commitments or undertakings an SOE may be required to provide to pass the “net benefit” test. These include commitments to appoint Canadians as independent directors, the employment of Canadians in senior management, the incorporation of the target business in Canada and the listing of shares of the acquiring company or the target Canadian business on a Canadian stock exchange.

The “national security review” process

In 2009, the ICA was amended to include a new national security review process that is in addition to the existing investment review process. The national security review provisions allow the Minister of Innovation, Science and Economic Development to review investments where the Minister has “reasonable grounds” to believe that the investment “could be injurious to national security”.

National security review could apply to the establishment of a new Canadian business, the acquisition of control of a Canadian business or the acquisition, in whole or in part, of an entity that carries on all or any part of its operations in Canada where the entity has any of: a place of operations in Canada, an individual(s) employed or self-employed in connection with the entity’s operations or assets in Canada used in carrying on the entity’s operations. Furthermore, unlike the investment review provisions under the ICA, national security review applies not only to the establishment or acquisition of control of a Canadian business, but also to minority investments in Canadian businesses. Furthermore, there is no minimum dollar threshold for national security review (i.e., investments in targets with low enterprise values are nonetheless potentially reviewable).

There is some uncertainty as to the potential breadth of a national security review, as no definition of “national security” is provided under the ICA. If, following review
and consultations with the Minister of Public Safety and Emergency Preparedness, the Minister of Innovation, Science and Economic Development is satisfied that an investment threatens national security, it would then be referred to the Governor in Council (i.e., the federal Cabinet). The federal Cabinet is empowered to prohibit closing of the investment, authorize the investment on condition that the non-Canadian investor provide written undertakings to the Government or implement the investment on terms and conditions contained in the order, or require the divestiture of the Canadian business.

The timeline for national security review is prescribed by regulation and has potential to add significant delays to the process of obtaining required regulatory approvals. If the maximum periods under the regulations are fully utilized, a national security review could take 130 days or longer (assuming a notice of possible review is issued).

As there is no formal pre-closing notification requirement in relation to a national security review if ministerial approval is not otherwise required prior to closing, it is possible that an investor may only learn that the transaction is subject to national security review following closing upon receipt of a notice from the Minister. However, even if notification is not required prior to closing, an investor may choose to file a notification in advance of closing in order to trigger the 45 day period in which the Minister of Innovation, Science and Economic Development must give notice of a review or possible review under the regulations.

Notifiable transactions

General

As discussed above, the ICA excludes many transactions from the investment review process. Most such transactions are, however, subject to a notification requirement. For instance, non-Canadians undertaking acquisitions that do not meet the thresholds discussed on page A8 above must nevertheless notify Investment Canada within 30 days of making their investment. Non-Canadians establishing new businesses in Canada must do the same unless the new business is “related” to their existing business. No notice is required if an investment is for an expansion of a non-Canadian’s existing business. The expansion into a related business that is deemed to bear on Canada’s cultural heritage or national identity is, however, subject to notification and potentially reviewable.

Once notification has been made in the prescribed form, the investment may proceed without further government attention.

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3 “Cabinet” refers to the Prime Minister and other politicians who make up the executive branch of government under Canada’s parliamentary system. In Canada, cabinet members are usually called “Ministers” rather than “Secretaries” and, also in contrast with the U.S., are simultaneously legislators (being either Members of Parliament (“MPs”) or, occasionally, Senators). Each Canadian province has a similar system of government.
Cultural businesses

An investment in a business that bears on Canada’s cultural heritage or national identity may be reviewed on the order of the federal Cabinet even where the normal thresholds for review have not been met. For further discussion see page A13 above.

The federal Cabinet has 21 days following notification of such an investment to decide whether to proceed with a review and to notify the investor if a review is to be conducted.

National Security

An investment that raises national security concerns may be reviewed if the Minister, after consultation with the Minister of Public Safety and Emergency Preparedness, considers that the investment could be injurious to national security and the federal Cabinet, on the recommendation of the Minister, makes an order for the review of the investment. For further discussion see page A13 above.

Sanctions

The ICA provides that where the Minister believes that a non-Canadian investor has acted contrary to the provisions of the Act, the Minister may send a demand requiring compliance. If the investor fails to comply with this demand, the Minister may seek court-imposed sanctions including (in the worst case scenario) fines and possible dissolution or divestiture of transactions completed without approval.

Other Foreign Ownership Constraints

Many other federal and provincial statutes and regulations can affect an M&A transaction involving foreign investors, either as laws of general application or specific legislation. Employment and environmental legislation are often major concerns, for example. In addition to these general concerns, however, are provisions in federal and provincial legislation that can specifically restrict the ability of non-Canadian interests to acquire a Canadian business. While these provisions are too numerous to discuss in detail, the following is a representative sample:

Foreign-ownership limits on specific business sectors

For example, the federal Telecommunications Act, Broadcasting Act, Bank Act and Insurance Companies Act place certain restrictions on foreign ownership in those sectors. Provincial legislation, such as Ontario’s Paperback and Periodical Distributors Act and Mortgage Brokers Act, or Quebec’s Cinema Act, can include prohibitions or restrictions against the practice of certain trades or the carrying on of certain kinds of business by non-Canadians or non-residents of the province.
Foreign ownership limits on specific businesses

Some Canadian businesses operate under specific legislation that restricts the degree to which they can be owned or controlled by non-Canadians. Such legislation includes the federal Air Canada Public Participation Act. Such restrictions generally relate to businesses that were privatized after having been Crown-owned.

Restrictions on the availability of incentives to some businesses

Another consideration in some foreign investment situations is whether a Canadian company might lose valuable government economic-development incentives were it to become foreign-owned. The federal Petroleum Incentives Program Act is an example.

Restrictions on foreign or non-resident land ownership

Some provinces have restrictions on the sale of land to non-Canadians or non-residents. Perhaps the best-known example is the Prince Edward Island Lands Protection Act, which places restrictions on the ability of non-residents of Prince Edward Island to own more than five acres of land in that province.
# M&A in Canada: Private Company Acquisitions

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M&A in Canada: Private Company Acquisitions

The acquisition of a privately held Canadian business is generally effected by one of three means:

- The purchase of assets;
- The purchase of shares; or
- Statutory amalgamation.

While privately negotiated acquisitions are generally exempt from the take-over bid provisions of securities legislation, they can still raise securities law concerns, e.g. when they require the issuance of securities as consideration for an acquisition.

The principal features of Canadian asset purchase and share purchase agreements will be discussed below, with uniquely Canadian features noted as appropriate.

Because statutory amalgamations are relatively uncommon in the privately-negotiated context, we will not discuss them at length here. Generally speaking, however, an agreement giving effect to the business terms of such a transaction (whether it is the actual amalgamation or not), would look similar to the share purchase agreement described below. Thus it would include comprehensive representations and warranties concerning each amalgamating corporation, pre-closing covenants, conditions of closing, etc.

Note that the primary focus of this chapter is on the buyer. It is also generally assumed that both the buyer and the seller are corporate entities dealing at arm's length and that the business is located in whole or in part in the province of Ontario.

Asset Purchase or Share Purchase?

Determining whether the acquisition of a privately held Canadian business will be completed by way of a purchase of assets or shares is driven by both tax considerations and non-tax considerations. The weight given to the various factors will depend on the circumstances of the transaction and the bargaining power of the parties.

Non-tax considerations

Setting tax issues aside for a moment, from the point of view of a potential buyer the greatest advantage of an asset purchase is probably that it can pick and choose the assets it will acquire and, perhaps more importantly, the liabilities it will assume. Thus it could leave accounts receivable, unwanted inventory, etc. with the seller. However, certain liabilities such as environmental contamination associated with

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1 Statutory amalgamations are discussed in Chapter C of M&A in Canada: “Acquiring a public company”.
real property, or a collective agreement relating to unionized employees of the business, for example, will flow by operation of law to the buyer in an asset transaction.

While the ability to be selective about what it acquires and what liabilities it assumes are highly attractive aspects of an asset sale, there are numerous respects in which a share purchase is advantageous to a buyer. Some of these advantages include the following:

**Share purchase involves fewer conveyancing documents and consents**

A share purchase is relatively simple from a conveyancing perspective, as little is required beyond the delivery of share certificates. However, where there are “change of control” provisions in contracts or regulatory permits, it will be necessary to obtain third-party consents (which can be costly, as noted below). An asset purchase, particularly in larger and more complex transactions, can involve large numbers of conveyancing, assignment and transfer documents for particular assets, such as real estate, leases, motor vehicles, contracts, intellectual property, etc., in addition to numerous third-party consents. The greater time and expense required to assemble the required documents and consents in an asset transaction is frequently one of the main reasons that a transaction will proceed as a share purchase.

**Share purchase simpler with respect to employment issues**

Depending on the province, an asset purchase may also entail a number of distinct issues relating to employees. Under Ontario law, for example, it will have to be decided whether some or all of the employees of the seller will be offered employment by the buyer (which party will be responsible for severance costs if employees do not accept offers), how pension benefits are to be dealt with, who will be responsible for accrued vacation pay, etc.

The law in Quebec, however, differs with respect to the treatment of employees in the context of asset purchases, so careful analysis should be undertaken with respect to that province where appropriate.

*See page B24 below for further information on employment issues.*

**Tax considerations**

A buyer or seller will generally balance the above-noted considerations with its tax position in determining whether to proceed by way of a share or asset purchase. Focusing only on tax considerations would generally lead sellers to prefer to sell their shares and buyers to prefer to purchase assets.
Share transactions

Canadian sellers generally prefer share transactions, for a number of reasons:

- Share transactions will generally give rise to capital gains (which are taxed at half the rate of ordinary income);
- As at 2016, an exemption of just under $825,000 (indexed to inflation after 2016) of capital gains may be available to Canadian resident individual seller disposing of shares of a "small business corporation" if certain other conditions are met;
- In a share transaction, a seller that is a corporation may be able to reduce its taxable gain by having the target corporation declare “safe income” (essentially tax-paid retained earnings) dividends prior to the transaction (as such inter-corporate dividends are generally non-taxable);
- In a share transaction, the overall tax payable may be less than on an asset sale, if the seller’s tax cost of the shares ("outside basis") is higher than the corporation’s tax cost of the assets ("inside basis"); and
- In a share transaction, the seller may have the opportunity to claim a reserve for any portion of the purchase price that is not payable until a later year. If the consideration is to include shares of a buyer that is a Canadian corporation, the seller may be able to take advantage of available tax deferrals or “rollovers”.

There may be other tax issues for the seller depending on the nature of the specific share transaction, including issues relating to the proper treatment of payments received under a deferred purchase price arrangement or earn out.

A buyer might prefer to purchase shares if the target corporation has significant non-capital tax-loss carry-forwards (i.e. business losses), since the only way for the buyer to acquire the tax losses of the target corporation is to acquire the shares of the target corporation.

However, a share purchase may also have certain tax-related drawbacks:

- A share purchase will generally result in a “change of control” of the target that triggers a year-end for tax purposes, requiring the target to file a tax return; and
- Provisions of the Income Tax Act (Canada) will impose restrictions on the use, after a change of control, of capital and non-capital losses. Non-capital losses are generally “streamed” on a change of control such that they may only be used to offset future income from the same or a similar business that generated the losses. Capital losses generally expire on an acquisition of control.

Elections may be available to write up the tax cost of the target’s capital assets immediately prior to the acquisition of control, effectively realizing accrued but unrealized gains, which may be sheltered by the capital losses that might otherwise expire.
Asset transactions

From a tax perspective, an asset transaction is generally more advantageous than a share transaction for the buyer. A buyer will prefer an asset acquisition because the buyer will get full cost base in the acquired assets which should (i) increase the deductions available to the buyer in respect of depreciable assets and (ii) reduce its gains should it subsequently sell any of the assets. As noted above, a buyer will also be able to purchase only selected assets in an asset transaction, and may be able to choose the liabilities (including tax liabilities) to be assumed.

When the purchaser is a non-resident, additional factors may come into play. Generally speaking, in the case of a non-resident purchaser, an asset transaction will provide greater flexibility from a structuring perspective. In certain cases (where the Canadian target derives significant value from shares of foreign subsidiaries for example), a non-resident purchaser may prefer not to hold the foreign assets in a Canadian corporation for either Canadian or non-Canadian tax reasons. Similarly, a non-resident purchaser may prefer to acquire certain assets using a Canadian corporation and certain assets using a non-resident entity. If the non-resident purchaser acquires shares, it may be impossible to take the non-Canadian assets out of the Canadian corporation post-closing without triggering significant Canadian tax. Therefore, in cross-border acquisitions, there may be even greater incentive to structure the deal as an asset purchase than in domestic acquisitions.

The seller may also prefer an asset transaction in certain circumstances. For example, if the target corporation has significant tax-loss carry-forwards, the seller may wish to sell assets to generate income or capital gains that can be sheltered with such losses.

Hybrid transactions

In order to capture some of the benefits of both an asset and a share transaction, it may be possible to structure an acquisition as a hybrid transaction that contains the desired elements of both. For example, the vendor may sell enough shares to claim the lifetime capital gains exemption and the buyer purchases preferred assets directly.

Other tax aspects of asset transactions

Although not determinative of the choice between an asset or share transaction, asset sales do have other implications that buyers should be aware of.

Allocation of purchase price

In an asset transaction, the allocation of the purchase price among the various assets is critical from an income tax perspective. Generally a buyer of assets in Canada would prefer to allocate the purchase price in the following order:

- Inventory (full deductibility);
- Depreciable capital property with a high rate of capital cost allowance (i.e. “tax depreciation”);
• Depreciable capital property with a low rate of capital cost allowance; and
• Non-depreciable capital property (e.g. land).
• (Note that beginning January 1, 2017 goodwill generally will be included in a new class of depreciable capital property and subject to a 5% rate of capital cost allowance).

In most instances a buyer and seller engaged in an asset transaction will have conflicting interests in making these allocations. A Canadian asset purchase agreement would typically include provisions dealing with the allocation of the purchase price among the purchased assets and a covenant of the buyer and the seller to prepare their financial statements and prepare and file their tax returns on such a basis.

Sales Taxes
The purchase of the assets of a business will generally involve a supply of at least some goods that are subject to federal “goods and services tax” (GST) and corresponding provincial taxes. The 5% GST applies nationally to supplies of goods, services and certain real and intangible property. However, the way that the GST interacts with provincial sales taxes varies in significant ways from province to province.

In Ontario and the four Atlantic Provinces, the federal GST and corresponding provincial sales taxes are combined into a single tax known as the Harmonized Sales Tax (HST). The HST applies in exactly the same way as the GST, but it is imposed at a rate of either 13% (Ontario) or 15% (New Brunswick, Newfoundland & Labrador, Nova Scotia and Prince Edward Island). In the province of Quebec, a slightly different approach is taken. Quebec imposes a 9.975% sales tax (QST) that, although collected independently, generally mirrors the GST. The GST is imposed separately (at its usual rate of 5%) in that province.

The GST/HST and QST are value-added taxes that are collected by the supplier of a good or service from the recipient, who may be able to recover the tax paid on supplies of goods or services used in its commercial activities through input tax credits and refunds. Even when fully recoverable, the payment of GST/HST and QST on the purchase of a business can create a cash-flow concern for the buyer. To address this, the parties may elect to have the assets of a business transferred with no tax payable if the buyer is acquiring all or substantially all of the property necessary to carry on the business and certain other conditions are met. A purchase of shares, by contrast, is considered to be a “financial service” and an “exempt supply”, so that no GST/HST or QST is payable when a business is acquired through a share sale.

Manitoba, Saskatchewan and British Columbia levy their own provincial sales tax (PST) at various rates on the sale or lease of tangible personal property and the provision of certain taxable services. Although it is not a value-added tax recoverable through input tax credits or refunds, PST is not imposed on the sale of
goods purchased for resale, land, buildings, fixtures, or intangibles (including shares). The application of PST to a sale of manufacturing equipment varies among the provinces. A seller proposing to sell its stock, equipment, or fixtures through a sale in bulk in a PST province must obtain a certificate from the provincial government, certifying that all PST collectable or payable by it has been paid. The buyer must obtain a copy of this certificate from the seller, or risk liability for any PST collectable or payable by the seller.

In Alberta and the northern Territories, the GST applies at 5%. There is no corresponding provincial or territorial tax in those jurisdictions.

**Land transfer tax**

Certain provinces, including Ontario, Quebec and British Columbia (and some municipalities), impose a land transfer tax (at varying rates) upon the transfer of real property or an interest in real property. In Ontario, for example, such taxes are approximately 2% of the sale price of the property, with an additional municipal tax payable within the City of Toronto. Note that some jurisdictions that have no or nominal land transfer taxes may have significant registration fees payable upon the registration of a transfer of real property.

**Tax considerations specific to cross border transactions**

**Foreign buyer issuing shares to seller: exchangeable shares structures**

Exchangeable share structures (also known as dividend access share structures) are often used in cross-border acquisitions where a purchaser proposes to acquire a Canadian target for consideration that includes issuing its own shares. The exchangeable share structure is used because Canadian tax law provides for a rollover (deferral of gain) only if a seller receives shares of a Canadian corporation.

To preserve a rollover for the Canadian shareholders of the target, a foreign buyer may form a Canadian subsidiary that will issue shares that are exchangeable into the buyer's shares. These exchangeable shares are intended to be the economic equivalent of the buyer's shares (for example they typically have a dividend entitlement that mirrors the dividends paid on the buyer's shares). The Canadian seller accepts the exchangeable shares in payment (or partial payment) on disposition of the target's shares. Because the Canadian seller receives shares that are issued by a Canadian corporation, the Canadian seller generally will not pay Canadian tax until those exchangeable shares are exchanged for the non-resident buyer's shares. There are a number of corporate and tax considerations to be addressed with respect to an exchangeable share structure, but in many cases such a structure can be implemented to the satisfaction of all sides.
Buying from a foreign seller: section 116 certificates (withholding) - real estate and resource property

Subject to certain exceptions, section 116 of the Income Tax Act requires a non-resident seller of “taxable Canadian property” to apply to the Canada Revenue Agency (CRA) for a clearance certificate with respect to the disposition or proposed disposition of such property either before, or within 10 days after, the disposition. A clearance certificate will be issued if the non-resident either pays the applicable amount in respect of the (proposed) disposition as a pre-payment of the non-resident’s Canadian tax payable, or furnishes security acceptable to the CRA. In the absence of a clearance certificate, generally the buyer must withhold a percentage of the purchase price (such percentage will be dependent on the type of property) and remit it to the CRA.

Taxable Canadian property includes real property situated in Canada, property used in a business carried on in Canada, and certain shares that derive their value from real property in Canada, Canadian resource properties, timber resource properties or options in respect of them. The section 116 clearance certificate requirement does not apply to certain types of excluded property, which includes listed shares, units of a mutual fund trust, bonds, debentures and property any gain from the disposition of which would, because of a tax treaty with another country, be exempt from Canadian tax (provided in certain cases notification is given to the CRA).

In an arm’s length sale of property that is subject to the section 116 requirement, the buyer would generally require the section 116 certificate on closing or withhold the applicable amount in respect of the purchase price until such a certificate is provided. A buyer who is not presented a required section 116 certificate and fails to make the necessary withholding, may be liable for the amounts that should have been withheld and remitted.

Legal Due Diligence

An integral part of the acquisition process is systematic due diligence by the buyer with respect to the target business, its assets and liabilities. Legal due diligence is generally based on a review of specified contracts, corporate documents and searches of the public records relating to the target and its property and assets. However, this review must be tailored to the specific circumstances of the transaction and the requirements of the buyer. Factors include the size and complexity of the transaction, the nature of the target’s business and its regulatory environment, the materiality threshold and significance of the transaction for the buyer, the degree of indemnification available from the seller, the buyer’s knowledge and expertise and the resources and time available.
Controlled Auctions

Controlled auctions are frequently used where a seller wishes to attain the highest possible value by attracting a pool of potential buyers within an orderly process that it controls. A controlled auction may include the following steps:

- Seller's own due diligence, with corrective action to prepare the business for sale;
- Deciding on an appropriate structure for the sale (e.g. asset or share sale). Personal tax or estate planning issues can be determinative here;
- Preparation and distribution of a short “teaser” document outlining the nature of the business for sale and the auction process;
- Preparation of a confidentiality agreement to be signed by potential buyers who want to receive a confidential information memorandum;
- Preparation and distribution by seller of a more comprehensive information memorandum concerning the company and its business;
- Selecting narrower group of bidders for next phase;
- Receipt of expressions of interest by potential buyers;
- Setting up a data room (either electronic or physical) to provide controlled access to company documents for selected bidder due diligence;
- Arranging controlled access to various key executives and management, management presentation, site visits, etc.;
- Circulation of a draft agreement to the selected group of bidders;
- Receiving formal binding offer setting forth the basic terms of the transaction, along with comments from the buyer on the form of a draft definitive purchase agreement and schedules; and
- Entering into a definitive purchase agreement following negotiation.

It is essential that the company and the business be in proper order before entering into the sale process. This may require the following:

- As buyers typically prefer audited financial statements and are generally suspicious of unaudited management statements, it may be necessary to anticipate a sale a year or two in advance and arrange for audited financials. This is especially important in the case of the sale of a division or carve-out transaction;
- Ensuring that the business can comply with public company certification requirements;
- Where there is important proprietary intellectual property (IP), ensuring that these assets of the business – the products or processes – are properly protected through patents, trademarks or copyright registrations, as appropriate. In addition, it is important to have non-disclosure agreements in place with relevant personnel and appropriate assignments and waivers in favour of the company;
• If selling shares, ensuring that the corporate records are up-to-date and complete, that all stock option or purchase plans are properly documented and that all share certificates have been issued and are held in safekeeping; and
• Regularizing and documenting all other legal aspects of the business including commercialization and distribution arrangements, real property leases, equipment leases, banking arrangements, employee arrangements, etc.

For further information about controlled auctions, please speak with your Stikeman Elliott contact for copies of our other publications on this topic.

Definitive Documentation

The purchase and sale of shares or assets of a Canadian business of any magnitude usually involves a number of documents, including a confidentiality agreement, letter of intent (often referred to as a memorandum of understanding, heads of agreement or term sheet) and a definitive purchase and sale agreement with disclosure letter and schedules. Depending on the transaction, ancillary documentation may include a non-competition and non-solicitation agreement, an escrow agreement, executive employment agreements, transition services agreements, etc.

Confidentiality agreement

It has become standard in Canada for a prospective buyer to enter into a confidentiality agreement. Such an agreement normally ensures that all confidential information provided to the buyer, whether written or oral and whether labelled as “confidential” or “proprietary”, is held in confidence and not used for any purpose other than the transaction in question. In addition, such agreements often deal with the non-solicitation of employees and customers for a stipulated period of time, among other issues. It is also becoming more common to insert provisions dealing with the “staging” of the release of competitively-sensitive information, as well as “non-solicitation of customer” provisions (if the transaction is not completed).

Letter of intent

A letter of intent or term sheet (LOI) can memorialize the basic terms of the deal and form the basis on which some regulatory and other third-party consents are sought and obtained.

Typical provisions

A Canadian LOI typically has both binding and non-binding provisions. Common binding terms can include:

• A period of exclusivity in dealing with a particular buyer (“no-shop”);
• Access for due diligence;
• Allocation of responsibility for expenses;
• The rules for public announcements;
• An outside “drop dead” date to enter into a definitive purchase agreement;
• Expense reimbursement and work fee if the transaction does not proceed (possibly with break-up fees);
• Confidentiality provisions (if a separate confidentiality agreement has not already been executed and delivered); and
• Conduct of the business in the ordinary course.

On the other hand, non-binding provisions typically include the “deal” terms, such as:
• The subject matter of the sale;
• The price and terms of payment;
• Key representations and warranties; and
• The material conditions of closing.

As in many other jurisdictions, Canadian jurisprudence is replete with examples of provisions of so-called letters of intent held to be binding, even though one party had arguably not intended to be bound. Even the insertion of the tried and true “subject to the execution and delivery by the parties of a definitive purchase and sale agreement” may not suffice, since the conduct of the parties might suggest that a binding contract has been entered into. Therefore, it is always helpful to ensure that the LOI is crystal clear on those provisions that are to be binding and those that are not using words that suggest intention (“would” rather than “will”) and inserting specific conditions within a party’s control, such as requiring either the board or the shareholders (or both) to approve the transaction.

**Purchase agreement**

Canadian purchase and sale agreements are similar to those used in many other jurisdictions. They typically include:

• Provisions dealing with the purchase, including the purchase price or other consideration, payment terms and the purchase price adjustment (if any);
• Holdback or escrow provisions;
• Comprehensive representations and warranties of the seller, as well as provisions dealing with the survival of the representations and warranties following closing. Normally the buyer will give less comprehensive representations and warranties except in particular circumstances (for example, where the securities of the buyer are consideration for the purchase);
• Pre-closing covenants;
• Conditions of closing in favour of both the buyer and the seller;
• Specific indemnity provisions; and
• General boilerplate provisions, including choice of law and venue.
Representations and warranties that would typically differ most from those in U.S., U.K. or other non-Canadian agreements tend to be those dealing with “local” matters, e.g. environmental requirements, taxes, labour, employment and pensions and benefits.

**Purchase price**

In a Canadian acquisition agreement, the consideration typically takes the form of cash, a promissory note or notes (in the case of a deferred purchase price), shares of the buyer or a related entity, or (in an asset transaction) the assumption of debt of the seller (possibly restricted to trade payables). Payment of the full purchase price in cash is appealing from a seller’s perspective since it will largely terminate the relationship between the buyer and seller at closing, absent post-closing financial adjustments and post-closing indemnity claims for breaches of representations, warranties and/or covenants.

Issuing debt securities of the buyer (such as promissory notes) can be attractive for a buyer, not only to avoid having to pay cash up-front, but also to provide effective leverage in negotiating indemnity claims or even having express set-off rights built into the debt security.

Additional issues are raised if equity securities are used as consideration and are to be publicly traded in Canada. These include:

- The requirement of “qualifying” the shares by prospectus and listing them on an appropriate stock exchange;
- Valuation of the buyer’s shares and possibly a formula using average closing price (such as the volume-weighted average of the closing prices of the shares for ten trading days, ending on a date which is, say, three business days prior to the closing date), a “collar” (e.g. “if such average price is less than X dollars or more than Y dollars, the average price should be deemed to be X dollars or Y dollars as the case may be”), a right to terminate the acquisition agreement if such average price extends beyond the collar limits and/or the right (but not the obligation) of the buyer to provide additional consideration, etc.;
- Restrictions on resale of the buyer’s shares under applicable securities legislation;
- Possible shareholder approval for the issuance of the buyer’s shares, depending on the available number of authorized but unissued shares, the rules of the applicable stock exchange, etc.; and
- Tax considerations, particularly if a “roll-over” for the purposes of the *Income Tax Act* (Canada) is desired.

**Post-closing purchase price adjustment**

One common purchase price provision in Canadian acquisition agreements is the post-closing purchase price adjustment typically based on changes in “working capital” (basically the book value of current assets such as cash, inventory and receivables less the book value of current liabilities) or some other financial metric.
such as “net worth”. Even though a business may be valued by a buyer on some multiple of sustainable earnings, discounted cash flow methodology or some other basis not directly related to the “net book value” of the assets of the business, buyers often insist upon an adjustment at closing to deal with any changes in its net worth or working capital (or other relevant financial measure) of the business between the date of the historical financial statements and closing. Because working capital adjustments operate in practice as a purchase price adjustment, these calculations can be detailed and complicated and should be reviewed by financial and legal advisors.

**Holdbacks**

Buyers in Canada will often insist upon holding back part of the purchase price to cover post-closing indemnity claims. The amount of the holdback may be paid to an escrow agent to be held for a predetermined time. This type of arrangement makes it easier for the buyer to recover amounts owing for indemnification claims, while alleviating concerns relating to the potential insolvency of the seller and the practical problems associated with executing judgments against a seller’s (or multiple sellers’) assets. If the seller is concerned about the current or future creditworthiness of the buyer, it will frequently prefer that the amount be deposited with a third-party escrow agent.

**Earn-outs**

A further variation of the purchase price provision in Canadian acquisitions (except in the case of a professional or service business), is the “earn-out”. An earn-out makes a portion of the purchase price contingent upon actual financial performance or other milestones during a specified post-closing period. The performance criteria on which the earn-out will be based can be non-financial (e.g. obtaining a new contract or the launch of new product), but are more commonly financial (e.g. revenues, earnings, EBITDA or net earnings). Earn-outs can help to bridge a valuation gap between buyer and seller and can also provide another means of set-off for indemnification claims. Earn-out provisions can be complex and are very deal specific. In addition to careful drafting, issues to consider in negotiating earn-out provisions include:

- **Duration: a realistic time period** – in Canada, earn-out periods are most typically one to three years, but can also run as long as 5 years;
- **Formula** – where the earn-out is based on financial performance criteria, specify the rules for the calculation of the financial metric, including the precise elements to be included or excluded from the calculation of the metric, any specified accounting rules, etc.; they are generally a function of earnings or EBITDA, often on a year-by-year basis or cumulatively and with an earnings shortfall in one year made up in another year and quite often with a “true up” at the end of the period;
• **Definitions of key financial concepts** – the manner in which earnings, EBITDA or other financial metric (whether it forms all or a part of the calculation of the earn-out metric) are to be calculated should be carefully spelled out (e.g. the financial statements must be audited and prepared on the basis of Canadian GAAP consistent with past periods); inter-company charges (those not on a fair market value basis), inter-company debt payments and extraordinary gains and losses are often excluded; note that private companies in Canada can elect to use the International Financial Reporting Standards (IFRS) or Canadian Accounting Standards for Private Enterprises;

• **Cap or limit on payments** – buyers will typically seek this, particularly where payments are a multiple or percentage calculated with reference to the target’s performance relative to a performance milestone set out in the earn-out; and

• **Impact of certain events** – address the impact of certain events (such as amalgamations, reorganizations and mergers, or sale of the assets) on the earn-out and provide for an acceleration or “buy-out” of earn-out payments upon a change of control or a sale of the assets. Other events may also be desirable to address, such as the termination of employment of certain key employees who were to maintain an active role in management during the earn-out period.

**Security for performance**

Holdbacks and other deferrals of the purchase price are examples of techniques that are used mainly at the insistence of buyers. However, Canadian transactions often use other payment security devices that, depending on the circumstances, might be requested or demanded by either party. One such device is the guarantee or the indemnity of a third party, such as a shareholder of the buyer or the seller. Depending on the recipient’s confidence in the guarantor and the extent of the assets available to satisfy the guarantee, the recipient may decide to take a security interest in some or all of the remaining assets of the seller in addition to the guarantee, or (alternatively) may secure the guarantee directly by taking a security interest in the assets of the guarantor. It should be noted that many Canadian corporate statutes no longer require the guarantor to satisfy certain restrictive solvency tests prior to giving any guarantee.

**Representations and warranties**

**Purposes**

The representations and warranties in a Canadian acquisition agreement serve a variety of purposes, including:

• To provide a basis for obtaining comprehensive information regarding the target (the “due diligence” purpose);

• To provide a remedy to the buyer after the closing of the transaction in the event the target, its business and assets were not correctly described to the buyer. This is accomplished through an allocation of risk between the buyer
and the seller reflected in the extent of, and qualifications to, the representations and warranties (the “allocation of risk” purpose); and

- To provide the buyer with a right to terminate the transaction, on or prior to closing, if material inaccuracies in representations and warranties are discovered before closing (the “right to walk” purpose).

In the Canadian common law context, it is useful to understand the distinction between representations, warranties, covenants and indemnification provisions. A representation is essentially a statement of fact as of a specific date, usually made with the intention of inducing another to enter a contract but, if not true, generally not intended to give rise to damages or the right to terminate the contract. A warranty, at its simplest, is a promise that a statement or a representation is true and is intended to give rise to damages but generally not the right to terminate the contract. In a typical Canadian acquisition agreement “representations” are contractually tied to “warranties” and thus, through the characterization as warranties, give rise to damages if untrue. A covenant is generally forward-looking, and generally refers to a promise or an agreement, in writing, either to do something or to refrain from doing something, and the usual remedies to correct a breach include not only damages but, in addition, the equitable remedies of specific performance and injunctive relief. An indemnification provision in a purchase agreement is another remedy which may be in addition to, or in substitution of, the regular actions for misrepresentation and breach of contract, which has the advantage of stipulating the manner and the extent to which a party is to be compensated for a loss. Covenants and indemnification provisions are discussed below. Finally, conditions are contractual provisions which, if not satisfied, give rise to the right to terminate an agreement and to damages in certain circumstances.

**Typical representations and warranties**

The typical representations and warranties in a well-drafted Canadian acquisition agreement would include the following given by the seller in favour of the buyer (generally for both asset and share transactions, except where otherwise noted):

**CORPORATE MATTERS**

- Due incorporation, organization and qualification to do business;
- Corporate authority to enter into the transaction;
- Confirmation that entering into the transaction would not conflict with articles, by-laws, applicable laws or material contracts;
- Confirmation that all necessary corporate authorizations and consents have been obtained;
- Confirmation that the acquisition agreement has been duly executed and delivered as a binding obligation; and
- In share transactions, confirmation of the authorized and issued capital of the target; confirmation of title to the purchased shares; confirmation of dividends
and distributions from a particular “benchmark” date; confirmation of the accuracy and completeness of corporate records; possibly confirmation that the selling shareholders are resident Canadians or that the shares are not “taxable Canadian property” of the seller (see the discussion of Section 116 of the Income Tax Act at page B8, above).

GENERAL MATTERS RELATING TO THE BUSINESS

- Confirmation that the business has been carried on in the ordinary course since a benchmark date;
- Confirmation that there has been no material adverse change in the business since a benchmark date (usually with a grocery list of specified activities, such as not having entered into material contracts, etc.);
- Compliance with laws; and
- Authorizations and consents required.

MATTERS RELATING TO ASSETS

- Sufficiency of the assets to enable the buyer to carry on business in the ordinary course following closing;
- Title to the purchased assets;
- Condition of tangible assets;
- Separate provisions dealing with particular types of property, including owned real property, leased real property, contracts (and no breaches), accounts receivable, inventory, subsidiaries and other equity investments;
- Warranties about assets/revenues used to determine thresholds under the Competition Act and the Investment Canada Act; and
- Warranties concerning registration under the Excise Tax Act and for GST/HST purposes.

FINANCIAL MATTERS

- Confirmation of the accuracy and completeness of books and records;
- Confirmation that the financial statements present fairly the financial condition of the company;
- Confirmation that adequate financial controls are in place;
- Adequacy of working capital (which may not be required where there is a working capital adjustment provision);
- Confirmation of “no liabilities”, except as disclosed in financial statements, in the purchase agreement or in the ordinary course; and
- In share transactions, provisions dealing with bank accounts and powers of attorney.

PARTICULAR MATTERS RELATING TO THE BUSINESS

- Environmental matters;
- Employees (unionized and non-unionized);
- Employee benefit plans and pension plans;
• Insurance;
• Intellectual property;
• Outstanding litigation and proceedings;
• Customers and suppliers;
• Taxes (in share transactions this would tend to be much more comprehensive);
• Compliance with privacy legislation; and
• Full disclosure (“10b-5”) (although this provision is not as common in Canadian agreements as it is in U.S. agreements).

Typical representations and warranties made by the buyer tend to be much more focused on the buyer's ability to enter into and perform its obligations under the definitive purchase agreement. Depending on the circumstances, but much more rarely, the buyer may also provide representations and warranties as to its financing commitment and the satisfaction of its due diligence review.

**Survival of representations and warranties**

In Canada, the right to bring an action with respect to breaches of representations and warranties is typically time-limited and is subject to negotiation. Under Ontario law, for example, there is a “default” limitation period of 2 years from discovery or discoverability on most types of action, which may be varied by agreement in most business law contexts.

**Pre-closing covenants**

Pre-closing covenants are used to control the period between signing and closing to ensure the completion of the transaction and that the value of the asset or shares being purchased is preserved. While pre-closing covenants are deal sensitive in nature, in both asset and share transactions they typically include a covenant to carry on the business in the ordinary course until closing (possibly coupled with a series of negative covenants), provisions dealing with access for the buyer and its representatives prior to closing to the business and assets and possibly personnel, a covenant from both parties to use reasonable commercial efforts (or best efforts) to ensure satisfaction with the stipulated conditions of closing and to obtain all required consents and regulatory approvals and possibly a covenant by both parties to advise upon becoming aware of any breach of the representations and warranties set forth in the agreement. Some pre-merger integrative planning is uncontroversial; however, pre-closing covenants (especially where the buyer and seller are competitors) that effectively treat the transaction as complete before the waiting period expires or unduly lessen the competition could contravene the Competition Act and expose the parties to sanctions.
Conditions of closing

Typically, a Canadian acquisition agreement will have conditions of closing, which generally include the following:

- The truth of representations and warranties at closing (possibly in all material respects);
- That all covenants have been complied with (once again, possibly in all material respects);
- Delivery of all required documentation (particularly in an asset purchase transaction);
- Delivery of any legal opinion or opinions (many transactions are completed without legal opinions);
- Delivery of all required consents (possibly limited to material consents);
- Delivery of all required regulatory approvals or passage of related waiting periods;
- Absence of any pending (or possibly threatened) litigation that could prevent or hinder the closing;
- No material adverse change; and
- Any other conditions unique to the particular transaction such as completion of due diligence to the satisfaction of the buyer or the obtaining of all necessary financing – the latter being quite dangerous from a seller's perspective.

Indemnification and representation and warranty insurance

It is very common in Canadian acquisition agreements to include a specific provision for indemnification for breaches of representations and warranties and breaches of covenants, as well as the costs associated with any such claims.

Representation and warranty insurance ("RWI") has become a mainstream transactional consideration. RWI allows sellers to cap their indemnification exposure and permits the prompt disbursement of the proceeds of a sale (net of any escrow requirements) to the seller's and to their securityholders without risk of repayment arising from post-closing indemnification claims. One of its most common uses is in a controlled auction process. For bidders, the use of RWI allows it to accept more 'seller-friendly' deal terms to make its bid more attractive to sellers and, at the same time, limit its risk exposure to increase the success of its bid. For sellers, it is a means to a quick and clean exit.

The cost of RWI may vary depending on if it is a 'buy-side' vs. a 'sell-side' policy and the amount of retention (deductible) applicable and currently range from approximately 2% to 4% of the coverage limit with a retention or deductible that ranges from approximately 1% to 3% of the transactional value. There is typically a drop-down in such retention amount payable typically 12-18 months after the effective date of the policy (this period generally matches the survival period set out in the purchase and sale agreement of many of the representations covered by the policy).
Coverage from RWI is limited to breaches of representations and warranties, additional indemnities may be negotiated to extend to other matters, such as ongoing litigation at closing or other known risks disclosed in due diligence, in respect of which the buyer expects to be fully covered (and which RWI will not cover). It is not uncommon to see a provision in the indemnity section declaring it (and potentially any RWI) the “exclusive” remedy under the agreement with carve-outs for fraud, specific performance and injunctive relief, as well as rectification, rescission, restitution and other equitable remedies.

Advantages

There are certain advantages to including the representations and warranties as matters to be indemnified for, instead of simply relying on a common-law action for breach of the representation and warranty. Principles of remoteness and mitigation normally apply to an action for breach of representation and warranty. Under an indemnity, on the other hand, these principles do not generally apply, since the claim is for an agreed sum. However, the amount that can be claimed as the loss under the indemnity would most likely be restricted to the amount that would otherwise be recoverable as damages for breach. In addition, with an indemnity, it may be easier to obtain summary judgment for the damages claimed, even before the buyer has actually made any payments to third parties. It should also be noted that in Canada the indemnity provisions normally include detailed mechanics on making claims for breaches of representations, warranties and covenants, as well as for third-party claims and, most importantly, for limitations of the scope of the indemnity.

Thresholds vs. deductibles

As is common in other jurisdictions, most Canadian acquisition agreements have a threshold or deductible for claims made under a Canadian acquisition agreement. A threshold would stipulate, as a pre-condition to an action under the agreement, that aggregate claims must exceed a certain dollar amount, but that there can be full recovery with respect to such claims. A deductible, on the other hand, merely establishes that the first stipulated dollar amount can never be recovered. The stipulated dollar amount thus effectively becomes a materiality threshold. Indeed, in some acquisition agreements the representations and warranties are essentially unqualified (i.e., there are no materiality or knowledge qualifications) and the deductible serves as the materiality threshold.

It is also possible to stipulate that individual claims must exceed a certain dollar amount, in addition to the aggregate threshold, before an action can be commenced.

Caps on damages

Another common feature of acquisition agreements in Canada is a cap or limit on the potential damages that can be claimed by a party under the acquisition agreement which is usually stipulated as a percentage of the purchase price.
common with another U.S. practice with respect to share-for-share transactions, there may be a limited recourse remedy, such that the buyer’s exclusive remedy for damages may be limited to a percentage of the shares received as consideration by the selling shareholders. This limit would match the cap held as security under an escrow arrangement for a pre-determined period of time. The escrow portion of the cash proceeds of the transaction could also serve the same function as a “limited recourse” remedy.

Post-closing covenants
In Canada there are typically fewer post-closing covenants than pre-closing covenants. Typical post-closing covenants include confidentiality obligations, the maintenance of books and records and, in asset transactions, possibly covenants to collect accounts receivable (assuming they were not part of the purchased assets), transitional services etc. In share deals, it is typical to see covenants with respect to the preparation and review of tax returns and the consequences of tax assessments.

Non-Competition and other restrictive covenants
One important post-closing covenant is the non-competition covenant. Under the common law as it exists in Canada, non-competition clauses are covenants in restraint of trade and generally unenforceable as contrary to public policy. Certain exceptions have been recognized by Canadian courts, however, including when non-competition provisions are linked to the sale of a business and properly drafted. In order to be enforceable, non-competition covenants must be reasonable.

Non-competition provisions can be incorporated directly into the purchase agreement but are more likely to be part of a stand-alone agreement. In addition to the “non-compete” covenant, the buyer will often insist on additional specific covenants, e.g. a covenant that prohibits the seller from hiring the buyer’s employees or soliciting clients.

The negotiation and drafting of non-competition and other restrictive covenants should take into account expansive tax rules that may be applicable to such covenants, to ensure there are no unintended tax consequences to the parties. These rules are discussed at the end of this section under the heading “Tax Implications.”

Reasonableness and severability: The length and scope of the non-competition covenant, as well as the consideration received for it and the context under which the restriction was agreed to, may all factor into the enforceability of such a provision. While no one factor is dispositive, a restrictive covenant cannot be too long in duration, too broad in geographic scope, or too broad in terms of the affected activity. The covenant should not exceed what is necessary for the reasonable protection of the interests of the purchaser. The reasonableness of the restriction will be assessed as of the time of the agreement, based on what is legitimately foreseeable at that time.
The importance of taking a reasonable approach to the scope, length and range of a non-competition covenant is reinforced by the reluctance of Canadian courts to rewrite contracts between parties, even by severance. An unreasonable or overly broad non-competition clause will not be enforced by Canadian courts and courts generally will not “blue-pencil” or write-down an overly broad non-competition covenant—unlike in the U.S., where courts may strike only the portion of the clause that is unenforceable and/or modify the clause to be enforceable—they will strike down the unreasonable or overly-broad non-competition provision in its entirety. Dealmakers are urged to seek advice of counsel when drafting such provisions.

**Drafting points:** In the context of an acquisition, the following practices may improve the likelihood that the non-competition covenant will be enforceable (Ontario law is assumed, but most or all of these points would apply in a similar way elsewhere in Canada):

- The restrictions should be reasonable and proportional to the consideration being provided (e.g. minority shareholders should not be subject to the same restrictions as other shareholders who are receiving significant consideration);
- Competition should be restricted only for as long as is reasonably necessary to adequately protect the intended beneficiary of the restrictive covenant. In Canada, in a purely commercial context, a non-compete period between 3-5 years from the date of closing, depending on the amount of consideration received, is generally enforceable;
- Limit the geographic scope of the covenants to where the vendor actually carries on business at the date of closing, although it may be possible to also address any real and reasonable plans for expansion of the business.
- The non-compete must apply to the business being purchased as it is at the date of closing only; it cannot capture unrelated or speculative future businesses of the buyer, or the growth or change of the business after closing. (This will affect both the description of the business and the territory to which it applies); and
- Consider avoiding a non-competition covenant if a non-solicitation provision would be sufficient.

**“Restrictive Covenant” is broadly defined for tax purposes**

Parties negotiating a M&A transaction should note that for income tax purposes, a restrictive covenant is any agreement, undertaking, or waiver of an advantage or right, whether legally enforceable or not, that affects, or is intended to affect, in any way the acquisition or provision of property or services by a taxpayer. This

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2 Blue pencil severance” refers to the legal technique that permits a court to strike out unenforceable or ambiguous words. Generally, Canadian courts will not use the blue-pencil technique to sever aspects of an unreasonable non-competition clause in order to render it reasonable, except in exceptional cases. (In contrast, “notional severance” refers to when an otherwise clear but unreasonable clause is read down to something reasonable, in order to give effect to the proper intention of the parties.) See Shafron v. KRG Insurance Brokers (Western) Inc., [2009] 1 S.C.R. 157.

3 A non-compete period in excess of 5 years would generally be viewed as unenforceable in Canada. In exceptional circumstances, however, courts have gone as high as 10 years. Also see Payette v. Guay Inc., 2013 SCC 45, [2013] 3 S.C.R. 95.
definition is potentially broader than a non-compete or non-solicitation covenant, and could include agreements that are neither restrictive nor covenants. For this reason, the rules applicable to restrictive covenants must be kept in mind when drafting other terms of an M&A transaction, including non-disclosure agreements, “break” or termination fees, and other inducement-type payments.

Default position is income inclusion

The default position, sometimes referred to as the “income inclusion” rule, is that a payment to a taxpayer as consideration for a restrictive covenant must be included, in its entirety, in the income of that taxpayer, subject to several exceptions and elections, and a reallocation rule, which are discussed below.

Exceptions to the income inclusion

The most common (albeit narrow) exceptions relevant to the M&A context include:

- The asset sale exception: This exception requires the grantor of the restrictive covenant to have agreed to the covenant in the course of selling a business and its underlying assets, and that the grantor of the covenant is carrying on the business (which is often not the case). A joint election between buyer and grantor must be made.

- Shares and partnership interests: This exception may be available where the restrictive covenant is a “non-compete” and relates directly to the disposition of an “eligible interest” in a partnership or corporation that carries on the business to which the restrictive covenant relates. Because an eligible interest is defined narrowly, this exception would not include shares held in certain complex corporate structures, although it might be possible to implement a pre-closing reorganization of the target to fall within the definition. A joint election is required and certain other conditions must be satisfied.

- Realization of Goodwill/Disposition of Property (subsection 56.4(7) exception): This exception is applicable only to non-compete agreements where a taxpayer realizes a goodwill amount or disposes of property or shares, and certain other conditions are met. Although some of the conditions are quite specific and complex, they generally can be met in most M&A deals, provided that no allocation of the purchase price has been made to the restrictive covenant and the restrictive covenant can be reasonably regarded as having been granted to maintain or preserve the fair market value of the shares, partnership interests or assets disposed of. In most cases (other than a realization of goodwill), there is no requirement to file a joint election. In transactions involving certain related individuals, this exception may not be available where the grantor is not resident in Canada.

Allocation must be reasonable or CRA can in some cases reallocate

The Income Tax Act requires a taxpayer to make a reasonable allocation of an amount received to a restrictive covenant. The Canada Revenue Agency (CRA) has the authority to reallocate a greater portion of the purchase price to the restrictive
covenant if it believes that the amount that has been allocated is unreasonable in the circumstances, including where no amount has been allocated to a restrictive covenant. This reallocation is prohibited in certain circumstances, including where the subsection 56.4(7) exception applies.

**Implications for M&A transactions**

Among the ways in which these rules affect M&A deals:

- **Consideration for the restrictive covenant:** As noted above, it is a condition to application of the subsection 56.4(7) exception that no amount of the purchase price is allocated to the restrictive covenant.

- **Valuing the non-compete:** Challenges remain as to how to value a restrictive covenant, particularly in the context of complex M&A transactions where the restrictive covenant is just one of the many representations and covenants made by a vendor and the CRA’s authority to reallocate purchase price to a restrictive covenant.

- **Non-resident withholding tax:** Amounts paid or payable to a non-resident person for a restrictive covenant that would otherwise fall within the “income inclusion rule” are instead subject to non-resident withholding tax at the rate of 25% (subject to any applicable tax treaty). Any liability for a failure to properly withhold will fall on the buyer. Accordingly, if a grantor of a restrictive covenant is a non-resident, the buyer will want to be very careful to determine whether any of the exceptions apply and ensure that an election, if required, is filed in the proper form and within the required time.

A failure to pay close attention to the restrictive covenant rules could have significant consequences for the parties to an M&A transaction, Given the complexity surrounding the rules, it is important to get corporate and tax counsel involved at an early stage in the negotiation of an M&A deal involving any sort of agreement that could be characterized as a restrictive covenant as defined in the Act.

**Boilerplate Clauses**

It is also typical of Canadian acquisition agreements to have a number of “boilerplate” provisions that can include substantive matters of interpretation and practical import. These would include clarifications of language and interpretation (e.g. capitalized terms, headings and references), accounting principles, currency and notices.

However, there are several provisions to which a foreign buyer should be particularly attentive. These include choice of law, venue for litigation, dispute resolution provisions and currency exchange clauses (in the event that the currency is other than Canadian dollars).
Employees

One of the most difficult aspects of an asset transaction is dealing with the employees of the business being sold. Contracts of employment are not automatically assigned to a purchaser of assets. Buyers will typically offer employment to many, if not all, employees of the business upon the closing of the transaction on the same terms and conditions as their employment with the seller (or on terms and conditions of employment no less favourable, in the aggregate, than they enjoy at closing). Accordingly, the seller will be responsible for terminating any employees whose employment cannot continue with the seller. Each employee generally has a duty to mitigate any losses suffered as a result of such termination by seeking alternative employment. An employee who refuses such an offer of employment will likely not have mitigated his or her damages and therefore would not likely have a claim for damages against the seller for “wrongful dismissal”. Employees who refuse offers of employment would still be entitled to their statutory notice and severance entitlements, which are discussed in more detail below. Canada generally has no concept of “employment at will”.

Quebec’s labour and employment laws differ in some significant respects from its counterpart in the common law provinces and territories.

Seniority retained when new employer re-hires employees

If the buyer offers employment to employees of the business and the employees accept those offers, employment standards legislation in most provinces (including Ontario) will deem their employment not to have been terminated or severed. Thus their periods of employment with the selling employer will be considered employment with the buyer for certain purposes, such as calculations of statutory holiday pay, vacation entitlement, pregnancy and parental leave, and subsequent notice and severance entitlements. Employers cannot contract out of the intent of such provisions by, for example, terminating employees on or prior to closing and having the buyer re-hire the same employees immediately after closing. Under Ontario’s Employment Standards Act, 2000, for example, provisions on continuity of employment apply explicitly where an employee is hired back up to 13 weeks subsequent to the sale (or subsequent to his or her last day of employment with the previous owner, if that was prior to the sale).

Seller responsible for payments where employee refuses buyer’s offer

A seller’s notice of termination (or pay in lieu thereof) and severance pay obligations (see below) must be read in the context of the relevant provincial employment standards legislation, which may provide (as in the case of Ontario’s Employment Standards Act, 2000) for the continuation of employment only if employment is offered by the buyer and accepted by the employee. Therefore, even if the parties agree that the buyer will offer employment to all employees of the business, an employee who refuses the offer of employment will still be entitled to
redress from the selling employer with respect both to notice of termination (or, more commonly, “pay in lieu” of notice) and severance pay obligations.

**Principles for calculating notice requirements and severance pay**

For employees who are not offered employment by the buyer, compensation upon termination is usually based on both the provisions of the relevant legislation and the common law. An exception to this is where the employee has a valid written agreement with the employer that specifically provides for the employee’s entitlements upon termination.

The required notice of termination (or pay in lieu thereof) and severance pay under the relevant statute will typically be a function of the years of service and, in certain circumstances, the aggregate number of employees terminated within specified timeframes. However, the common law requirement to provide “reasonable notice” is often in excess of statutory requirements and will, in most cases, need to be taken into account. Reasonable notice at common law is a function of a broader range of factors, including years of service, age, seniority, position, availability of alternate employment and other special considerations, including the circumstances surrounding the hiring of the employee at the commencement of employment. Common law reasonable notice is inclusive of, not in addition to, the statutory requirements described above.

**Unionized workplaces**

The buyer of a business will generally be bound by any collective agreement to which the seller is bound. This includes becoming a party to any pending application for certification or termination of bargaining rights before the relevant provincial labour relations board to which the seller was a party. It should be noted that these provisions are broader than those under Ontario’s *Employment Standards Act, 2000* and apply whether or not a buyer offers employment to the seller’s employees. Moreover, as labour law is a provincial and territorial responsibility, it will always be necessary to consider the particular legal requirements of each of the Canadian jurisdictions in which a business operates.

**Company Pension and Retirement Plans**

There are different vehicles potentially used by employers in Canada to provide pension benefits to employees – primarily defined benefit registered pension plans (similar to defined benefit qualified plans in the U.S.), defined contribution registered pension plans (similar to defined contribution qualified plans such as 401(k) plans in the U.S.), group registered retirement saving plans (similar to IRAs in the U.S.) and deferred profit sharing plans (similar to thrift plans in the U.S.). Defined benefit plans often pose the greatest challenges in an M&A transaction, and this section focuses primarily on such plans.
While it is rare for pension issues to make or break a corporate deal, every transaction involving a pension plan nonetheless has important legal and financial implications for both the buyer and the target. More often than not, the pension options available to the parties will be dependent on a predetermined mode of acquisition. In order to minimize the risks associated with acquiring or divesting pension liabilities, both the buyer and the target need to be aware of their respective options as well as the definite and potential consequences that flow from each. This section discusses the effect typical deal structures have on the options available to the buyer and the seller given the nature of the target company’s pension arrangements.

**Pensions and the simple share deal**

The least complex to document is the simple share deal in which the target company sponsors its own pension plan. It is simple because (i) all plan assets and liabilities remain with the plan and all funding obligations remain with the target, and (ii) the buyer cannot pick and choose the pension obligations it assumes. For example, a buyer cannot leave behind pension obligations in respect of former employees or insulate the target or the plan from an unresolved partial wind-up. As a result, thorough due diligence review of all plan-related documents is essential.

With volatility in plan funding, a potential buyer will want to ensure it understands fully the target’s funding obligations and the implications of a pension surplus or deficit in the context of the transaction, and may wish to seek its own actuarial advice on the size of any surplus or deficit so as to ensure the purchase price properly reflects the target’s pension obligations.

When access to full information and thorough review are not feasible, well-crafted representations in a purchase agreement can provide some comfort to the buyer. In that in the event that a purchase agreement representation reveals itself to be untrue, damages recovery is usually time limited to a few years or less while many pension issues take several years to surface. That said, the target must be careful in providing overly broad or potentially untrue representations. The Ontario Court of Appeal decision in *Transamerica*,^4^ provides an example of a pension deal that was essentially undone due to inaccurate representations regarding the target’s pension obligations.

**Pensions and the classic asset deal**

In the classic asset purchase deal, a buyer is buying certain assets, usually a division of a larger company, where the larger company sponsors a pension plan for all its employees, including employees of the target business division. The principal options and the consequences that stem from a share purchase versus an asset purchase as it relates to pension obligations are discussed below.

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**Option 1: No pension plan offered**

Pre-sale pension liabilities of employees of the target business division remain with the plan; however, where a buyer offers employees no pension plan, depending on the jurisdiction in which the plan is regulated, the regulator may have the discretion to declare the plan partially wound-up. Assuming the plan is a defined benefit plan, a partial wind-up could have several costly implications for the company from which the division is being acquired.

Employment law considerations are also important. The company could face costly wrongful dismissal claims from employees of the business division if the terms of employment offered by the buyer are not substantially similar to those they had previously enjoyed. Specifically, the selling company risks having employees of the business division refuse the buyer’s offer of employment, thus forcing the company to terminate them. If the other components in the buyer’s compensation package do not adequately compensate for the loss in future pension accruals, the selling company could be liable for the costs associated with terminating the refusing employees. As a result, it would be usual for the selling company to insist that the purchase agreement require affected employees be offered a compensation package which, in the aggregate, is no less favourable than that received from the selling company immediately prior to the sale, or that the buyer agrees to cover any termination costs in the event that the offer falls short in this respect.

Where the plan is a defined benefit plan, it may be difficult for the buyer to craft a compensation package for long-service employees that provides a comparable level of benefit without actually offering defined benefits. For the remaining options discussed below, we will assume that the plan is a defined benefit plan.

**Option 2: A pension plan for future service only**

Here, the buyer offers a defined benefit plan to employees of the target business division but assumes no pre-sale pension liabilities from the company from which the division is being acquired. In this case, the selling company and the plan retain responsibility for delivering pre-sale pensions accrued to employees of the division under the plan. In this circumstance, Ontario’s *Pension Benefits Act* requires that years of service recognized under the plan be recognized in the buyer’s plan for purposes of determining eligibility for membership in, and benefit entitlement under, the buyer’s plan and vice versa.

The foremost advantage of option 2 is its simplicity: service with the selling company remains the selling company’s responsibility, while service with the buyer will be the buyer’s responsibility.

In the longer term, however, option 2 loses some of its appeal. First, the buyer and the company from which the division is being acquired would be required to exchange member information every time an employee of the division terminates employment, retires, or dies. Second, in the case of employees in Ontario, if the buyer terminates the employment of the employee, other than in specified
circumstances, the pension plan may be liable to pay potentially expensive grow-in enhancements as described earlier. Finally, in some cases, older, long-service employees may suffer a loss in pension with years of membership in two plans rather than all years in just one plan. To address this, buyer could provide a “wrap” for employees so that their benefits are not adversely affected; however, wraps can be costly and complicated.

Option 3: Asset transfer

In this case, buyer offers a defined benefit plan to employees of the division and assumes liability for their past service under the plan with a corresponding transfer of a proportionate share of assets from the plan to the buyer’s plan.

In all likelihood, the assets transferred from the plan will not equal the liabilities transferred to the buyer’s plan. If the plan is in surplus, the surplus will often be transferred, likewise if the plan is in deficit, assets less than liabilities will transfer. An additional top-up contribution on the transfer amount or a purchase price adjustment can address this either inside or outside the plan.

The main advantage of Option 3 is the clean break that it makes between buyer and selling company. After the transfer is complete, no requirement to exchange information exists. Moreover, the plan will be unaffected by future terminations of the employees in the buyer’s plan. One disadvantage is that an asset transfer requires the most up-front time and attention by the buyer and the selling company: the parties must quantify the transferring liabilities and often the assumptions by which they are to be valued, perform an in-depth review of historical plan documentation as well as draft and file a multitude of reports and plan documents with FSCO (or the corresponding agency in other jurisdictions) – all at considerable expense. Advice from actuaries, lawyers and accountants should also be sought. Even with “simple asset transfers”, regulatory approval for the transfer generally takes a year and often considerably longer.

No option

Where a collective agreement covers employees of the division, its terms may require the buyer to provide certain pension arrangements thus rendering it a legal and practical necessity for the buyer to “choose” a particular option. Where the plan is incorporated by reference into the collective agreement and exists only for the employees of the division, a purchaser may be required to assume the plan in its entirety. However, where the collective agreement requires a particular level of pension benefit or where groups of employees other than employees of the division being acquired participate in the plan, the buyer may not be required or able to assume the plan. Instead, the buyer may be required to establish a new plan providing for identical benefits or even to negotiate a new deal with the union. In any case, the terms of any collective agreement must be fully fleshed out to determine the buyer’s obligations.
Variations on the theme

Not every deal is a “simple share deal” or a “classic asset deal”. Depending on the target company’s structure, from a pension perspective, a share deal may more closely resemble an asset deal. For example, where two subsidiaries (A and B) participate in a pension plan sponsored by A, a buyer buying the shares of B will be faced with the three options noted above but with a twist: the employment law considerations will apply directly to B as it will remain the employer of the affected employees before and after the sale.

The above discussion is illustrative but not exhaustive of the many important issues that can arise for buyer and seller in any transaction involving a pension plan. Early attention in the deal process, adequate due diligence and documentation, and consultation with experts including actuarial, legal and accounting professionals can help both quantify and minimize the associated risks.

Canada Pension Plan issues

In addition to company pension plans, most Canadian employees also benefit from the government-sponsored Canada Pension Plan, to which employers make contributions. Canada Pension Plan obligations are an issue in asset sale transactions, and are discussed further at page B31 below.

Privacy Legislation

In Canada, legislation at the federal level and in the provinces of Alberta, British Columbia and Quebec, regulates the collection, use and disclosure of personal information by private sector organizations. The implications of this legislation must be considered in the context of the disclosure of personal information for due diligence purposes and in connection with the closing of the sale of a business.

Personal information is any information about an identifiable individual or any information that allows an individual to be identified. Generally, personal information does not include an individual's name, business title, business address or business telephone number.

The federal Personal Information Protection and Electronic Documents Act (PIPEDA) applies to the collection use and disclosure of personal information by: (i) federally-regulated organizations carrying on commercial activity in Canada (such as banks, airlines, and telecommunication and broadcasting companies); and (ii) other private sector organizations when personal information is collected, used or disclosed in a province other than Alberta, British Columbia or Quebec or is transferred across provincial or national borders. PIPEDA does not apply to organizations that are not engaged in commercial activity (for example, not-for-profit and charity groups, although such organizations are not automatically exempt) and will not apply to an organization that operates wholly within a province that has legislation that has been deemed substantially similar to the PIPEDA, unless the personal information
crosses provincial or national borders. Alberta’s and Québec all have private-sector legislation which has been declared to be substantially similar to the PIPEDA and will apply to private-sector businesses that collect, use and disclose employee personal information while carrying on business within those provinces.

The fundamental principle underlying the federal and provincial privacy legislation is that the consent of the individual is required for the collection, use and disclosure of their personal information. The federal and provincial privacy legislation in Alberta and British Columbia contains a business transaction exemption to the consent principle if certain conditions are satisfied. Consequently, if an organization is only subject to that privacy legislation and if the organization satisfies the specified conditions, it can disclose personal information without the consent of the individuals to a prospective buyer for due diligence purposes and in connection with the closing of the sale of the organization’s business. In the event that a transaction is consummated, certain conditions will need to be met for the buyer to continue to use and disclose such personal information pursuant to the consent previously provided. In addition, either the buyer or seller is required to notify the individuals within a reasonable time after closing of the completion of the transaction and the disclosure of such individuals information in connection with the transaction. The Québec privacy legislation does not have a business transaction exemption.

Most provinces in Canada have legislation dealing with personal health information collected, used or disclosed by specified health care professionals or specified health care entities (e.g. doctors, dentists, hospitals, medical clinics, pharmacies). The implications of this legislation must be considered in the context of the disclosure of personal health information for due diligence purposes and in connection with the closing of the sale of a business, if the business is carried on by a health care professional or health care entity subject to the legislation.

**Special Considerations in Asset Transactions**

Asset sales involve complexities that are not present in share transactions. These include employee issues (as discussed above), dealing with accounts receivable, tax concerns, and requirements under pensions legislation. In addition, there are important shareholder approval requirements under the applicable business corporations statute.

**Accounts receivable**

In Canadian asset transactions, the buyer will often either purchase the accounts receivable (usually those that are less than 90 days old and/or at a discount from the face amount) or not purchase them while agreeing to collect them in the ordinary course for the seller. In the first case, there is often a provision that allows the buyer to reassign uncollected receivables after a stipulated period of time, e.g. 90 days following closing.
Where a seller is selling all or substantially all of the assets of a business to a buyer who proposes to carry on the business, they will normally make a joint election under Section 22 of the *Income Tax Act* (Canada) with respect to accounts receivable which it is acquiring. One purpose of doing so is to permit the buyer to take a deduction from income in the year of purchase (or in a subsequent year) on account of doubtful accounts or bad debts associated with the purchased receivables.

**Canada Pension Plan**

In an asset purchase, the buyer will be considered a new employer for the purposes of the Canada Pension Plan (CPP) and the contributions required thereunder. Therefore, the buyer will be required to withhold and match all required CPP contributions, notwithstanding the fact that all payments and deductions for the year may have been made by the seller prior to closing. While an employee can recover any overpayment in CPP contributions on filing his or her income tax return, an employer cannot. Accordingly, consideration should be given to the timing of any transaction involving a substantial number of employees in order to avoid the double payments. Alternatively, it may be possible to defer transferring the employees of a business until the beginning of the calendar year by entering into some form of secondment agreement with the seller with respect to such employees.

In Quebec, the provincial Quebec Pension Plan (QPP) operates in the place of the CPP. In an acquisition, QPP issues are usually similar to those that arise with respect to the CPP.

**Obligations under workplace safety legislation**

Provincial workers’ compensation legislation such as Ontario’s *Workplace Safety and Insurance Act* (WSIA) replaces an employee’s right to sue an employer for losses arising from workplace accidents with a statutory compensation fund. The record of the seller will be relevant to a buyer in connection with the payments due under WSIA, because the buyer will inherit the work record of the seller, which determines the level of payments that it will have to make.

In addition, when an employer sells, transfers or otherwise disposes of all or part of its business, either directly or indirectly, the buyer, as a successor employer, is liable for all amounts owing under the WSIA by the employer immediately before the disposition. The Regulations to the WSIA provide a mechanism for a buyer to obtain a “clearance certificate” prior to closing.

**Risk of loss**

As a matter of common law, a prospective buyer of a business which has entered into an asset acquisition agreement may have a beneficial interest in the subject assets and arguably the risk of loss or damage to such assets on or prior to closing.
may fall upon the buyer. Accordingly, the acquisition agreement should clearly provide whether the seller or the buyer will bear the risk of loss or damage to the assets prior to closing and what options, if any, are open to the buyer should damage occur. Such options might include the ability to walk from the deal if the loss or damage is material, the ability to close the transaction and retain any insurance proceeds with respect to such loss or damage, or the ability to set off against the purchase price the book value (or other amount, such as replacement value) of the assets lost or destroyed. Usually the risk remains with the seller. As the assets become the property of the buyer at closing, the buyer should make appropriate arrangements for its own insurance coverage to be effective from at least that date. As noted above, it is arguable that the buyer has an insurable interest in the assets by virtue of the acquisition agreement and accordingly may wish to place its own insurance on the assets prior to closing.

**Shareholder approval and dissent rights**

The *Canada Business Corporations Act* (CBCA), *Business Corporations Act* (Ontario) (OBCA) and many of Canada’s other business corporations statutes provide that a sale, lease or exchange of all or substantially all of the property of a corporation, other than in the ordinary course of business of the corporation, requires shareholder approval. “All or substantially all” is defined in this context by reference to both quantitative and qualitative factors. Such approval commonly takes the form of a special resolution (which requires a two-thirds or three-fourths majority). In addition, these statutes normally provide that where the sale would affect a particular class or a series of shares in a manner different from another class or series of shares of the corporation which are entitled to vote on the sale, then the holders of a class of shares which are so affected, even if they are not ordinarily entitled to vote, are nonetheless entitled to a right to vote in the circumstances.

It should also be noted that under both the CBCA and the OBCA, shareholders who are entitled to vote with respect to approval of a resolution to sell, lease or exchange all or substantially all of the corporation’s property are entitled to dissent and have their shares purchased by the corporation for fair value in accordance with the rules set forth in the statutes.

**Directors’ duties**

In an asset deal, the board of directors of the target corporation will have the same basic duties in reviewing the transaction as a board of directors in the public M&A context: the duty to manage, the statutory fiduciary duty and the statutory duty of care.

**Canadianizing the Document**

Quite often, U.S. and other foreign buyers prefer to use their own acquisition documents, even if such documents are to be governed by the laws of Ontario or
another provincial jurisdiction (which, in either case, would include the laws of Canada applicable therein). Aside from some definitional matters requiring consideration and possible tailoring, such as “Business Day”, “Damages” (or “Losses”), “Employee Benefit Plans”, “Environmental Laws”, “Generally Accepted Accounting Principles”, “Laws”, “Permitted Encumbrances” and “Taxes”, there are some uniquely Canadian matters or practices to be considered.

**Dispute resolution**

Differences between the legal systems of Canada and those of the U.S. and other jurisdictions can affect a company’s dispute resolution strategies.

**Litigation**

Litigation is the traditional method for settling disputes under Canadian acquisition agreements. Designating the courts of a Canadian province as the exclusive or non-exclusive forum for litigation proceedings is often an acceptable alternative for all parties, as the Canadian judicial system is very well developed. In addition, discovery procedures generally only involve parties to the action itself and not all potential witnesses. Jury trials are extremely rare in civil cases in Canada.

Canadian courts tend to be conservative in assessing damages. Large awards of punitive or exemplary damages are uncommon. In this context, it should also be noted that successful plaintiffs can recover a significant part of their costs through awards. Contingency fees are permissible but less common than in U.S. jurisdictions.

**Arbitration**

In Canada, as elsewhere, arbitration has become a popular method of dispute resolution. The typical benefits of arbitration are thought to be confidentiality, cost, speed, avoidance of jury trials, ease of enforcement and finality. In cases where all of the parties are Canadian and actions would be brought in Canada, an arbitration provision should not be included as a matter of course (see the above comments regarding the Canadian judicial system). In cross-border transactions involving parties from multiple jurisdictions, the case for settling disputes by arbitration is much more compelling and is often recommended. Rights of appeal from an arbitration decision are very limited under Canadian law and a high level of deference is typically afforded to arbitrator’s decisions by Canadian courts.

Arbitration clauses are often broadly worded and Canadian courts have taken an expansive approach to what is the proper subject matter of arbitration when such broad clauses are used, including a fiduciary duty claim that does not directly relate to a particular clause in the agreement in question and an oppression claim under a shareholders agreement. Further, as the federal government remains a signatory to the 1958 New York Convention on the Recognition and Enforcement of foreign Arbitral Awards, provincial and federal courts continue to enforce arbitral awards from other New York Convention States.
Once the parties have made a decision to arbitrate their disputes, they must then decide whether they will follow an institutional or ad hoc arbitration process. In circumstances where there are parties from multiple jurisdictions or an action could be brought in a foreign jurisdiction, institutional arbitration is preferred. However, sophisticated domestic parties may prefer an ad hoc arbitration as it can provide them greater control over the arbitration process and allow them to tailor the process to their circumstances. If the parties designate an arbitral institution, that appointment will determine which procedural and substantive rules will govern the arbitration of potential future disputes. There are many privately-operated Canadian institutions that specialize in arbitration services, the most prominent being ADR Chambers, the ADR Institute of Canada and ICDR Canada (although the latter is actually based in New York). These institutions’ rules are comparable to the UNCITRAL Arbitration Rules. In addition, international arbitrations occurring in Canada are frequently conducted under the auspices of foreign arbitral institutions, such as the International Chamber of Commerce, the London Court of International Arbitration or the international Centre for Dispute Resolution.

**Currency**

In most cases, references to “dollars” in an acquisition agreement governed by Canadian law would mean Canadian currency.

**Judgment currency**

Judgments in Canada must be rendered in Canadian currency. Generally speaking, if there is a possibility that an award (e.g. of damages) rendered in one currency would need to be converted into another currency, a clause which sets out the applicable rate and date of exchange should be included, together with an indemnity to cover any discrepancy between the amount originally owed and the amount of currency purchased in order to satisfy the award.

**Sale of goods**

What are commonly referred to as the “warranties” of merchantability and fitness for a purpose in connection with a sale of goods are referred to as “conditions” of merchantability and fitness for a purpose under most provincial sale of goods statutes. Therefore a well-drafted “entire agreement” clause in a Canadian acquisition agreement would refer to the fact that such agreement excludes any and all representations, warranties and conditions, express or implied, statutory or otherwise.

Application of the United Nations Convention on Contracts for the International Sale of Goods (commonly known as the Vienna Convention) should also be disclaimed in the context of cross-border deals.
**Third-party beneficiaries**

Under Canadian common law, the general rule of privity of contract survives (except in New Brunswick, where it has been abolished by statute) meaning that a contract cannot confer rights or impose obligations arising under it on any person except the parties to the contract. Put simply, only the parties to a contract have the right to sue under it. However, the rule has been eroded in Canadian courts over recent years, particularly where a third party wishes to rely on a clause as a “shield” and not as a “sword” (although that has been permitted). Accordingly, it is advisable to expressly state the intention of the contracting parties in a “third-party beneficiary” clause in the purchase agreement, in order to make it clear what third-party rights are excluded (or included). Quebec’s civil law also extends contractual rights to third-party beneficiaries.

**Language**

Acquisition agreements drafted under the laws of the province of Quebec must, if written in the English language, incorporate a clear statement, in French as well as English, that the parties intended the agreement to be drafted in the English language.
# M&A in Canada: Public Company Acquisitions

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M&A in Canada: Public Company Acquisitions

When its target is a Canadian public company, a prospective acquiror can choose from a number of acquisition mechanisms, such as a **take-over bid**, which is comparable to a U.S. “tender offer” and primarily regulated by securities laws, or various “one step” transactions provided for under corporate law, such as a **statutory plan of arrangement** or a **statutory amalgamation**.

The choice of mechanism will depend in part on whether the acquisition is friendly or hostile. A hostile (or “unsolicited”) acquisition will usually take the form of a take-over bid, while a friendly (or “negotiated”) acquisition can use any of the mechanisms.

*Note: There are also a number of distinct requirements if the bidder is already an insider of the target. See the discussion of “Related party transactions” in Chapter E of M&A in Canada: “Minority Shareholder Protections”.

**Negotiated Approach or Unsolicited Bid?**

A threshold question for a prospective acquiror is whether to proceed with an acquisition in a negotiated or unsolicited manner. This typically depends on a number of factors that need to be assessed in light of the particular circumstances.

**Negotiated approach**

A negotiated transaction proceeds on the basis of an agreement between the target and the acquiror. Factors that militate in favour of a negotiated approach include:

- The acquiror desires the transaction to be supported and recommended by the target board of directors;
- The bidder needs to conduct non-public due diligence on the target;
- The target’s value depends heavily on management or employees who might leave in the event of a hostile acquisition;
- A structured, negotiated transaction would produce desired tax benefits;
- The bidder wants to avail itself of “deal protections” (such as “no-solicit” provisions and “break fees”) that are only available in negotiated transactions; or
- The target is in a highly concentrated or regulated business (regulatory concerns being potentially more easily resolved in the context of a negotiated deal).

Typically, the most attractive aspect of a negotiated acquisition is the target’s co-operation, both in the lead-up to the transaction (e.g., through due diligence access) and in its execution (e.g., in obtaining the required regulatory and shareholder approvals). Access to confidential information in a negotiated transaction is generally subject to confidentiality and “standstill” provisions.
negotiated with the target (i.e. no offer may be made, or securities acquired, for the standstill period without the prior approval of the target’s board).

**Unsolicited acquisition**

An unsolicited (hostile) acquisition may be desirable or necessary where:

- Attempts at a friendly acquisition have failed;
- The value of the target’s co-operation is more limited, such as where the target is vulnerable and there are few, if any, competing bidders on the horizon; or
- The bidder’s objective is not necessarily to succeed in acquiring the target but to serve as a catalyst to provoke an auction to realize value on an existing investment or to “force” industry consolidation.

While not quite as common in Canada as they are in the U.S., unsolicited bids are by no means unusual. It is also not uncommon for an acquisition that begins with an unsolicited bid to be concluded, once the parties have accepted the inevitability of a deal, as a negotiated transaction.

**Acquisition Mechanisms**

Having determined whether to proceed with an unsolicited or a negotiated approach, it will next be necessary to consider the mechanism of the acquisition. This section outlines the requirements and relative merits of the three most commonly used public M&A acquisition mechanisms:

- Take-over bid;
- Plan of arrangement; and
- Statutory amalgamation.

**Take-over bid**

The take-over bid is the Canadian equivalent of the U.S. “tender offer”. A take-over bid is defined by a bright-line test in Canada as an offer to acquire outstanding voting or equity securities of a class that would bring the holdings of the bidder (and its joint actors) to 20% or more of the securities of the class. Complex counting rules apply in determining these ownership percentages. Note that the take-over bid process is often used in Canada to effect “friendly” acquisitions, particularly where all-cash consideration is being offered.

The take-over bid rules in Canada were significantly amended in early 2016. Key amendments include the extension of the mandatory bid period from 35 days to 105 days (which may be shortened to no less than 35 days in certain circumstances) and the introduction of a minimum tender condition whereby more than 50% of the outstanding securities owned by persons other than the bidder and joint actors must be tendered and not withdrawn before the bidder can take up securities under the bid.
Cash offer or share offer?

Take-over bids can offer cash, shares or other forms of securities (or some combination of these) as consideration. In the case of all-cash or partial-cash bids, Canadian securities laws require that adequate financing arrangements be in place before the launch of the bid to ensure that funds are available to pay for tendered shares. In other words, bids conditional on financing are not permitted.

Among the factors pertinent to the decision whether to proceed by way of a cash offer or a share offer are the following:

- **Disclosure** – If a bidder’s securities are to be offered, prospectus-level disclosure of the bidder and the resulting business is required, although there is generally no securities commission review of the offer document. For various reasons depending on the nature of the offered securities, discretionary exemptive relief may be required from securities commissions which may involve a review of the take-over bid circular. In contrast, a lower level of bidder disclosure is required for an all-cash offer. The information necessary to allow reasonable shareholders to make an informed decision about whether to tender their shares must, in any event, be disclosed;

- **Target shareholders’ preferences** – Generally, institutional shareholders will prefer cash, particularly where there are alternative investment vehicles in the target’s industry. Founders and other insiders may prefer share consideration in part due to the tax considerations discussed immediately below; and

- **Tax considerations** – An offer of shares of a Canadian bidder may provide a tax deferred roll-over to Canadian target shareholders. If the target shareholders have capital losses rather than capital gains, however, this will not be an advantage. Institutional shareholders are largely non-taxable, so a share deal may not hold any special attraction for them from a tax perspective.

Launching the bid

The bidder is required to deliver a take-over bid circular (containing the terms and conditions of the offer, as well as certain other required disclosure) to the shareholders of the target and to those holding securities that are convertible into shares, together with a French translation. It must also be delivered to the directors and auditors of the target. The delivery of this circular will generally mark the formal commencement of the take-over bid, except where the bidder elects to commence its bid by way of advertisement, as discussed below.

In order to deliver the circular to shareholders, the bidder must obtain the shareholder list, which the target company has a legal obligation to furnish. In the case of an unsolicited bid, this can be highly problematic, as a request prior to the bid will obviously tip off the target. To avoid this problem, Canadian securities legislation generally allows a bid to be commenced by a newspaper advertisement, before a shareholder list is obtained. In that case, the 105-day period starts upon publication of the advertisement. However, a request for a shareholder list must be made on or before the publication of the advertisement. The bidder must file the bid...
and advertisement with the applicable securities regulatory authorities and must send the bid to the target no later than the date of publication of the advertisement and must mail the bid to shareholders within two business days of receiving the shareholder list.

Note that, under a take-over bid, all shareholders must be offered identical consideration (or an identical choice of consideration) and collateral agreements are generally not permitted, with certain exceptions.

Once the bidder’s take-over bid circular is delivered to securityholders, the target’s board of directors is required to prepare and deliver to securityholders, within 15 days of the bid, a directors’ circular containing one of the following:

- A recommendation to accept or reject the bid or a statement that the board is not making (or is unable to make) a recommendation; or
- A statement that the board is considering whether to recommend the bid (in this event the board may choose to advise securityholders not to deposit their securities under the bid until the board advises them whether or not it will be recommending the bid (or that it will refrain from making any recommendation), which it is required to do no later than 7 days prior to the scheduled expiry of the initial period during which securities may be deposited under the bid).

If the board does not make a recommendation to accept or reject the bid, it must state the reasons for not doing so.

Valuation

In the case of an insider bid (as defined under MI 61-101), absent an exemption or discretionary relief, the bidder will generally be required to include in the disclosure document for the insider bid a summary of a formal valuation of the securities of the target (if it wishes, it may include the entire valuation). This valuation would be prepared by an independent valuator selected and supervised by an independent committee of the directors of the target, but paid for by the bidder.

Timing and duration of bid

The minimum period for the deposit of the target’s securities under a take-over bid is 105 calendar days. This period may be shortened by the target to no less than 35 days by the target issuing a news release announcing such shorter period or announcing its intention to effect an “alternative transaction” (which includes any type of transaction agreed to or initiated by the target that could result in the acquisition of the target or its business). In each case, all outstanding or subsequent contemporaneous bids will be subject to such shorter period. If all terms and conditions of the bid have been complied with or waived and more than 50% of the target’s securities subject to the bid, excluding securities owned or controlled by the bidder and any of its joint actors, have been tendered to the bid and not withdrawn, the offeror must issue a press release to this effect and extend the bid period by at least 10 days to allow remaining securityholders to tender to the bid.
No securities may be taken up by the bidder until the initial bid period has expired and all terms and conditions of the bid have been satisfied or waived (except for the minimum 50% deposit condition which must be satisfied but cannot be waived), at which point the offeror must take up the securities and pay for them no later than 3 business days after being taken up.

As noted above, a take-over bid can be commenced by the mailing of a take-over bid circular or by means of an advertisement (in a newspaper). One practical difference between these approaches is that the first requires that a securityholder list be obtained in advance while the second requires only that a request for one be made before the advertisement is published.

Subject to the rights of securityholders to withdraw securities, a take-over bid may be kept open as long as the bidder wishes or needs to achieve satisfaction of its conditions, subject to the target announcing a shorter period. If there is any variation in the terms of the take-over bid, the deposit period must remain open for at least 10 days after the notice of variation is sent to securityholders (except where the variation is a waiver of a condition, and any extension of the bid resulting from the waiver, in an all-cash bid – in which case no extension of the deposit period, other than the mandatory 10-day extension, is required, provided that a press release is promptly issued). An increase in consideration, however, requires the deposit period to remain open for at least 10 days after the notice of variation.

It should be emphasized that, in an insider bid context, the preparation of the valuation (subject to applicable exemptive relief) must be complete before the take-over bid circular can be finalized, because the summary of the valuation must be disclosed in the take-over bid circular. Although MI 61-101 requires the target’s independent committee to use its best efforts to ensure that the formal valuation is completed and provided to the bidder in a timely manner, this process can potentially take several weeks and, in the hostile bid context, can become contentious.

**Take-up and payment**

Deposited securities must be taken up immediately at the expiry of the initial deposit period, assuming all of the terms and conditions of the take-over bid have been complied with or waived and the minimum tender condition has been satisfied, and must be paid for as soon as possible thereafter and in any event within 3 business days of being taken up. Securities deposited during the mandatory 10-day extension period, or an extension of the bid made thereafter, must be taken up and paid for within 10 days of deposit.

**Changes and extensions**

If there is any change in the information contained in the take-over bid circular that would reasonably be expected to affect the decision of the securityholders to accept or reject the take-over bid, a notice disclosing the nature and substance of the
change must be sent to each person to whom the original circular was sent (unless the change is not within the control of the bidder or of an affiliate of the bidder, unless it is a change in a material fact relating to the securities being offered in exchange for securities of the target issuer). In addition, the bid must be extended for 10 days after mailing the notice of variation and a press release promptly issued.

Any variation in the terms of the take-over bid (including an extension or reduction of the deposit period) requires a notice of variation to be prepared and sent to each securityholder whose securities have not been taken up. For this purpose, it does not matter whether the variation results from the exercise of any right contained in the take-over bid (e.g. the waiver of a condition). An all-cash take-over bid cannot be extended (other than the mandatory 10-day extension) if all the terms and conditions have been complied with (except any that may have been waived by the bidder), unless the bidder takes up the securities deposited to the bid by the expiry of the bid.

A notice of change or variation gives rise to withdrawal rights, subject to certain exceptions.

**Financing cash offers**

If the consideration offered under a take-over bid includes cash, “adequate arrangements” must be made before the take-over bid is commenced to ensure that the bidder has the required funds available to complete the acquisition. This does not preclude the existence of conditions to its financing, but the bidder must reasonably believe the possibility is remote that it will not be able to pay for tendered securities because any of the conditions to its financing cannot be met. Generally, all material financing conditions should also be conditions of the bid itself. This obligation makes cash tender offers which require financing difficult in certain cases. As noted below, this requirement does not technically apply in plan of arrangement or amalgamation transactions.

**Conditions**

There is no specific prohibition on the types of conditions that may be included in a take-over bid, with the exception of a condition as to financing, given the requirement to arrange financing in advance. However, CSA Staff Notice 62-305 expresses the securities regulators’ general view that “the offeror’s conditions to a formal take-over bid should be *bona fide*, and should be interpreted in good faith and on a reasonable basis.”

Conditions may be waived by the bidder. Except for cash bids, the take-over bid must be kept open for 10 days after sending the notice of variation relating to the waiver to the securityholders.

The bidder may elect not to take up securities under the take-over bid if any condition has not been met (unless it is waived by the bidder).
The target board’s response

A target directors’ circular must be prepared and sent to target shareholders within 15 days of the date of the bid. The directors’ circular must include the recommendation of the board of directors of the target to accept or reject the takeover bid and the reasons for that recommendation or, alternatively, it must include a statement that the board is unable to make or is not making a recommendation, again with reasons.

In a negotiated deal, the parties will typically agree in advance, as part of the target’s support agreement, to have the directors’ circular recommending the bid mailed contemporaneously with the bid circular.

If a target’s board of directors is considering making a recommendation but has not had time to reach a decision, the directors must advise the shareholders of this at the time they send their circular and may advise shareholders not to tender until the directors have communicated their recommendation. Where a target’s board of directors decides to delay making a recommendation, the directors must send their recommendation to the shareholders not later than seven days before the scheduled expiry of the bid.

*Note that if an individual director or officer of the target wishes to make a recommendation, he or she may do so by preparing and submitting his or her own circular.*

Acquiring sufficient support

Once a bid is launched and the recommendation of the target board is made, the bidder’s next concern will usually be to get as many shareholders as possible to tender to the offer. A bidder will often engage the services of an information agent and/or dealer manager (to form a soliciting deal group) to assist in gaining support for the offer. In a hostile deal, the target company will also often engage an information agent to assist it in thwarting the bidder’s advances. In a friendly acquisition, the bidder will also often seek to negotiate a lock-up or voting agreement with major shareholders before launch.

The means by which the bidder can ultimately acquire 100% of the target’s shares depends on the degree of acceptance of the initial offer:

- **Where at least 90% (of the securities not owned by the bidder and its affiliates) accept the offer** – If 90% or more of the shares not owned by the bidder and its affiliates are tendered within 120 days of the date of the bid, then the remaining shares can generally be acquired through a statutory compulsory acquisition provided for in the corporate legislation under which the target was incorporated. Shareholders that do not tender their shares may have “dissent rights” that may entitle them to a judicial determination of the fair value of their shares.
• **Fewer than 90% (of the securities not owned by the bidder and its affiliates) accept the offer** – If fewer than 90% of the shares not owned by the bidder and its affiliates are tendered, the bidder can take up the tendered shares and extend its bid in an effort to reach the 90% threshold (although the bidder would not generally do this unless it will own at least a “majority of the minority” of the shares and at least 66 2/3% of the total outstanding shares, thus ensuring that it will at least end up controlling the target even if it does not ultimately manage to acquire 100% of the target shares under the bid). If, having extended its bid, the bidder still does not reach the 90% threshold, it can generally proceed with a second-step squeeze-out transaction that would require approval by special resolution (66 2/3% or 75% of votes cast, depending on the target jurisdiction) and “majority of the minority” approval.

Note that, if the intention to carry out a second-step transaction is disclosed in the take-over bid circular, minority shares tendered into the first step take-over bid may be voted by the bidder and counted for purposes of second-step minority approval thresholds (subject to certain restrictions relating to unequally treated locked-up shares).

**Conditions attached to the bid**

The following are among the conditions most frequently attached to Canadian take-over bids:

• **Minimum tender** – Historically, the minimum tender condition has most commonly specified a minimum of 50% of the outstanding minority shares and 66 2/3% overall (or 75%, depending on the target’s jurisdiction) deposited and not withdrawn, on a diluted basis. The higher the threshold, the “weaker” the bid, as the potential power of a small number of holdouts increases. The 50% minority share minimum tender condition is now required by National Instrument 62-104 – *Take-over Bids and Issuer Bids* (“NI 62-104”) and cannot be waived; however, the minimum tender condition does not preclude a bidder from requiring that a greater percentage of securities (i.e., 66 2/3%) be tendered to the bid.

*Note that the bidder can specify the 90% compulsory acquisition threshold and then waive the condition if it attains the 50% and 66 2/3% general squeeze-out transaction approval threshold. However, a waiver of a condition in a non-cash bid requires a 10-day extension;*

• **Regulatory approvals** – All regulatory approvals, domestic or foreign, have been obtained (or waiting periods expired) on reasonably satisfactory terms;

• **Material adverse change** – No change in the business or affairs of the target, and (perhaps) no change in the financial markets or general economic conditions that, in the opinion of the bidder, would have a material adverse effect on the value of the shares of the target;

• **No existing or pending litigation** – No suit against the target has been commenced or threatened which would have a material adverse effect; and
• **No legal impediments** – No legal prohibition that would stop the bidder from proceeding with the take-over bid or from taking up and paying for the shares, and no laws have been enacted or proposed that would adversely affect the target.

There is a wide latitude with respect to other conditions that might be needed to address specific concerns, but, as noted above, a condition with respect to obtaining financing is not permitted. Note also that conditions (other than the 50% minimum tender condition) may be waived, although in a non-cash bid this generally requires that the bid be kept open for ten days after notice of waiver has been sent to target shareholders.

**Plan of arrangement**

A plan of arrangement is a court-sanctioned procedure that allows a company to reorganize itself, to combine with another company (or companies) or otherwise to effect one or more fundamental changes including the acquisition of the company’s securities for cash or other form of consideration. This method of planning an acquisition transaction is frequently used in Canada because the applicable corporate statutes (i.e. the federal *Canada Business Corporations Act* (CBCA) and its provincial and territorial counterparts) allow a wide range of transactions to be implemented in this way, giving the courts broad discretion to approve plans of arrangement. Once negotiated between the prospective bidder and the target, the plan of arrangement will be submitted to the target’s securityholders for their approval and, assuming that approval is obtained, ultimately to the court for its approval.

A plan of arrangement allows the share capital of the target to be reorganized such that the interests of its securityholders would be terminated in exchange for a cash payment or other securities. It also allows for more conditional financing, generally making it the preferred method in a negotiated acquisition.

An arrangement under the CBCA becomes effective when articles of arrangement are filed and a certificate obtained under the CBCA. Similar rules apply under most other corporate law statutes.

**Cash offer or share offer?**

The considerations here are similar to those that apply to take-over bids. For example, in a non-cash transaction, prospectus-level disclosure about the bidder and the offered securities will be required. And absent relief, non-Canadian/non-U.S. companies offering securities may be required to reconcile or conform their financial statements, MD&A and auditors’ reports to IFRS standards.

**Arrangement agreement**

Parties wishing to proceed by this method typically negotiate an arrangement or merger agreement setting out the terms and conditions under which the
arrangement is to be completed. The arrangement agreement includes (as a schedule) a draft plan of arrangement – the document that, once approved by securityholders and the court and filed under the CBCA (or similar statute), effects the acquisition.

**Valuation and fairness opinion**

A plan of arrangement may also require a valuation to be carried out in certain circumstances by an independent valuator. The formal valuation must also be filed concurrently with the sending of the proxy circular to the securityholders of the target.

It is also common for the target’s board of directors to obtain an opinion from its financial advisors as to the fairness, from a financial point of view, of the consideration under the plan of arrangement.

**Information circular**

The proposed plan of arrangement is submitted for approval by the target to the affected securityholders, which will require the preparation by the target of a management proxy circular. This proxy circular must comply with the requirements of applicable corporate and securities laws and must generally provide securityholders with all relevant material information respecting the proposed arrangement.

**Securityholder approval**

Because a plan of arrangement is a court-supervised process, a judge will determine how the shareholders’ meeting will proceed, the level of required approval, and the voting entitlements of the various affected securityholders. Typically, an arrangement will require approval by the votes of the holders of two-thirds of the shares of the target cast at a special meeting of securityholders. In the case of a “business combination” under MI 61-101, “majority of the minority” approval may also be required.

As a result, prior to the special meeting, the target company will apply to the court for an interim order authorizing it to call the special meeting and setting out the ground rules to be followed, including the division of the securityholders into classes for purposes of approving the arrangement, the level of approval that must be attained with respect to each securityholder class and any special rules that are to govern the conduct of the meeting. All of these matters are at the discretion of the court (subject to any mandatory voting requirements that may be provided for under applicable corporate law) and are technically subject to change by further court order or to challenge at the final hearing, although this is not common. The typical approach of the courts is to divide securityholders who are affected differently into different classes for approval purposes. For example, common shareholders would typically be in one class, preferred shareholders potentially in another and possibly debt holders in another. Whether option holders should be
able to vote on a plan of arrangement (and if so, whether as part of the class of common shareholders or as a separate class) is an issue that has yet to be definitively settled in Canada.

Dissent rights

Although the CBCA, OBCA and similar statutes do not create an automatic dissent and appraisal right in all arrangements, they generally specifically grant the court the power to include a right of dissent in its order and in practice such rights are almost always granted to securityholders by the court. The effect of the dissent right is to allow a dissenting securityholder to receive the fair value of the securityholder’s shares (or other securities) in the target. An acquirer will often seek to cap its exposure to dissent rights by conditioning its obligation to complete the arrangement upon there being no more than a prescribed maximum level of dissenting shareholders.

Court approval

The process of obtaining court approval for a plan of arrangement will involve a minimum of two court appearances in the context of the transaction. The first appearance will be to apply for an interim order (as discussed above). The second appearance will follow the holding of the securityholder meetings to obtain the court’s approval of the arrangement.

The statutes as such do not give any guidance to the court as to the factors to be considered in deciding whether or not to approve an arrangement. However, the test that Canadian courts have developed for approving an arrangement is that it be “fair and reasonable”. Specifically, the “fair and reasonable” test requires that a court must first establish that the statutory requirements have been complied with and second that the arrangement is such that, in the words of one English judge, “an intelligent and honest man, a member of the class concerned, and acting in respect of his interest, might reasonably approve.”

Timing

There are certain minimum time requirements, under both corporate law and National Instrument 54-101 – Communication with Beneficial Owners of Securities of a Reporting Issuer, for the calling and holding of a special meeting of securityholders. These requirements, as well as the need to prepare a management proxy circular, will in most circumstances require a minimum of 40-60 days between the time the parties have agreed to proceed by way of a plan of arrangement and the plan of arrangement becoming effective.

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In non-arm’s length transactions, the preparation of the valuation must be complete before the proxy circular can be finalized. The valuation would often be completed before the arrangement agreement is entered into, but if not then this could further delay the securityholder meeting.

Impracticability

Some of the corporate statutes (e.g. the CBCA and the Alberta Business Corporations Act) provide that an arrangement is not to be used unless it is not practicable to effect the specified transaction under another provision of the Act in question. However, the courts have generally taken a liberal approach in allowing arrangements and have interpreted the “not practicable” requirement as meaning “difficult to put into practice”. Other statutes (e.g. the Ontario and British Columbia Business Corporations Acts) do not make impracticability a requirement even in this limited sense.

Statutory amalgamation

“Amalgamation”, like the similar U.S. “merger” concept, is a statutory means of combining two or more corporations incorporated under the same statute into one continuing amalgamated corporation. Under Canadian law (unlike U.S. law), both parties to a merger survive: the “Amalco” has all of the property, assets, rights and liabilities of each of the amalgamating corporations (an analogy that is often used to describe this is that of two rivers coming together and continuing as one).

Amalgamation is generally tax neutral, although it does trigger a tax year-end for each amalgamating corporation. It is also very efficient from a commercial perspective as assets and liabilities are usually not considered to be transferred or assumed. Rather, they shift to the Amalco as the result of the operation of the statute, which means (among other things) that an amalgamation, in and of itself, generally does not trigger consent requirements or transfer taxes.

Approval process

Shareholder approval is required of each amalgamating corporation. However, unlike a plan of arrangement, court approval is generally not required to effect an amalgamation. Where a transaction is to proceed by way of an amalgamation, the interests of the target’s shareholders would typically be directly or indirectly terminated in exchange for a cash payment (or other securities) upon the amalgamation. An amalgamation under the CBCA, for example, will become effective when articles of amalgamation are filed and a certificate obtained under the CBCA.

Amalgamating across jurisdictions

It should be noted that where the amalgamating companies are incorporated under different business corporations statutes, it will be necessary to continue those companies that are not already incorporated in the jurisdiction of choice into that jurisdiction, if practicable. Otherwise a “three-cornered amalgamation” can often be
considered, particularly where public companies are involved. Under such a procedure, the acquiror incorporates a new subsidiary under the target’s statute and amalgamates the subsidiary with the target. Once this has occurred, the former shareholders of the target are issued shares in the acquiror (or other satisfactory consideration) and the acquiror takes all the shares of the subsidiary, thereby gaining complete control of the target and its business.

Cash offer vs. share offer

The considerations here are similar to those that apply to take-over bids. For example, in a non-cash transaction, prospectus-level disclosure about the bidder and the offered securities will be required. And absent relief, non-Canadian/non-U.S. companies offering securities may be required to reconcile or conform their financial statements, MD&A and auditors’ reports to IFRS standards.

Amalgamation agreement

Once an amalgamation has been chosen as the desired procedure, the bidder and the target will enter into an amalgamation agreement. Although the agreement will take the form of a contract between the amalgamating corporations, the applicable business corporations statute will typically require that certain matters be addressed, e.g. the basis on which the holders of shares in the amalgamating corporation will receive money or securities in the amalgamated corporation in exchange for their shares.

Valuation and fairness opinion

Depending on the circumstances, a valuation may also be required if a transaction is effected through an amalgamation. As noted above, under MI 61-101 the formal valuation must also be filed concurrently with the sending of the proxy circular to the target’s shareholders.

It is also common for the target’s board of directors to obtain an opinion from its financial advisors as to the fairness, from a financial point of view, of the consideration to be received by its shareholders pursuant to the amalgamation.

Proxy circular

The proposed amalgamation is submitted for approval to all shareholders entitled to vote, which, like a plan of arrangement, will require the preparation by the target of a management proxy circular providing shareholders with all relevant information respecting the proposed amalgamation, including a copy of the amalgamation agreement.

Securityholder approval

The amalgamation will require approval by the votes of holders of 66 2/3% of the shares of the target cast at a special meeting of securityholders (75% in some
jurisdictions). All shares are entitled to a vote and there could be class voting as well. In the case of a “business combination” under MI 61-101, “majority of minority” approval may also be required.

Dissent rights
When carrying out an amalgamation, shareholders are entitled to dissent and appraisal rights by statute. Such rights allow a dissenting shareholder to receive the fair value of the shareholder’s securities. As in a plan of arrangement, an amalgamation can be made conditional upon there being no more than a prescribed maximum level of dissenting shareholders.

Timing
As discussed above with respect to plans of arrangement, there are certain minimum time requirements, under both corporate law and National Instrument 54-101 – *Communication with Beneficial Owners of Securities of a Reporting Issuer*, for the calling and holding of a special meeting of securityholders. These requirements, as well as the need to prepare a management proxy circular, will in most circumstances require a minimum of 40-60 days between the time the parties have agreed to proceed by way of a plan of arrangement and the plan of arrangement becoming effective.

In non-arm's length transactions, the preparation of the valuation must be complete before the proxy circular can be finalized. The valuation would often be completed before the arrangement agreement is entered into, but if not then this could further delay the securityholder meeting.
<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td>• No need to deal with management or board of the target prior to launch</td>
<td>• Significant risk of not meeting the 90% of non-owned shares threshold needed for a compulsory acquisition of the remaining shares. If that happens, the remaining shares can generally be acquired only after a shareholders’ meeting to consider a second-step squeeze-out transaction, plan of arrangement or similar transaction requiring majority of the minority shareholder approval. This lengthens the acquisition process, during which time the bidder is usually more restricted in its ability to deal with the target.</td>
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<td>(can do so if desired, however).</td>
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<tr>
<td>• More pressure on target board to react.</td>
<td>• Less opportunity for due diligence prior to a hostile bid, generally other than through public documents. Access to confidential information in a negotiated bid or arrangement would likely be subject to confidentiality and “standstill” provisions such as a requirement not to make an offer without the approval of the target’s board.</td>
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<td>• Bidder maintains greater control of documentation, although target board is obligated to produce a directors’ circular.</td>
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<tr>
<td>• Allows bidder to deal directly with the securityholders of the target and allows a bidder more flexibility in making changes to its offer.</td>
<td>• Limited flexibility to effect ancillary re-organizations of target that may be desirable for tax planning or other reasons.</td>
</tr>
<tr>
<td>• Potential timing advantages, especially if target shortens the deposit period and 90% of non-owned shares are tendered.</td>
<td>• Generally face deal competition risk until all conditions are satisfied (or waived) and shares are taken up, which can be relevant in the event of a lengthy regulatory approval process.</td>
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<td>• Take-over bid generally does not require court approval.</td>
<td>• No “dissent cap” beyond the minimum tender condition, which is usually two-thirds.</td>
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<td>• If proceeding with an unsolicited or hostile bid, experience has shown that a target board recommendations is meaningful.</td>
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### Amalgamation

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td>• No court approval required. Do not have to deal with the uncertainty of how the court will view the transaction.</td>
<td>• Not as flexible as a plan of arrangement.</td>
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<tr>
<td>• Allows the acquisition to be completed in a single step, with a level of approval and dissent rights that is substantially similar to those applying in a plan of arrangement.</td>
<td>• In an amalgamation with a share exchange, the 3(a)(10) exemption under the Securities Act of 1933 (U.S.) is not available.</td>
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### Plan of Arrangement

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<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tr>
<td>• A plan of arrangement is by far the most flexible means of effecting creative and complex acquisitions.</td>
<td>• Less control of timing and process from bidder’s perspective as target’s board of directors will control process and timing of court and shareholder approval (subject to what is negotiated by the acquiror with the target).</td>
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<tr>
<td>• Allows acquisition of 100% of the securities of the target in a single transaction (no need for a follow-up transaction).</td>
<td>• Co-operation of target generally required.</td>
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<tr>
<td>• In an plan of arrangement with a share exchange, the 3(a)(10) exemption under the Securities Act of 1933 (U.S.) is available.</td>
<td>• Lengthy process: negotiations (particularly on price) can drag on.</td>
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<td></td>
<td>• An arrangement can be subject to some uncertainty as a result of the requirement that the court ultimately determines that it is “fair and reasonable” to the parties affected. While court approval ultimately provides better insulation from attack, the requirement for such approval provides a relatively convenient and inexpensive forum for disgruntled securityholders or others to intervene in the process, thereby creating a risk of delay or (if the challenge is successful) of a change in terms of the transaction or even of its failure.</td>
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Pre-Approach Steps

A number of steps may be taken in anticipation of proposing an acquisition. These reflect the maxim that it is always best to leave as little as possible to chance.

Toe-Hold Purchases

Some potential acquirors will take “toe-hold” stakes in their targets. There are a number of reasons to do so, including reducing the numbers of potentially adverse shareholders and enhancing one’s financial position (i) by buying some shares at a lower price than the eventual bid price (subject to “pre-bid integration” requirements, as discussed below) or (ii) by profiting from a run-up of the share price should a rival create and win a competitive bid situation.

There are legal and practical limits to this strategy, however. When a potential acquiror’s (or anyone’s) holdings reach the 10% level, a number of requirements are triggered, including immediate disclosure (required at 5% if another bid is outstanding or if the target is a U.S. reporting issuer), as well as becoming subject to technical insider bid rules. From a practical point of view, taking a toe-hold may increase the perception of “hostility” and – most obviously and importantly – may tip off the target or a potential competitor of a potential acquiror’s intentions, which in turn could increase the market price or allow the target to take pre-emptive measures against the bid.

Other points to bear in mind are:

- That acquiring a significant toe-hold may take time if it is to be done without tipping anyone off or causing a price movement;
- That the toe-hold must be accomplished carefully in order to avoid violating insider trading prohibitions and to avoid triggering “pre-bid integration” requirements for equivalent all-cash follow-up offers;
- That toe-hold shares will not be counted for the purpose of the 50% minimum tender condition and therefore may make such condition more difficult to satisfy;
- That shares acquired prior to an offer are not counted for the purpose of the 90% threshold for compulsory acquisitions or for the purpose of the majority-of-the-minority vote in a second-step amalgamation;
- That the potential acquiror may be left holding the stock if the transaction is not completed and/or no competing offer is made and completed; and
- That if during due diligence the potential acquiror becomes apprised of material undisclosed information about the target, insider trading laws may prevent it from disposing of the toe-hold (until the information is publicly disclosed) in the event that the transaction does not proceed.

Note that the anonymity of buying on the TSX without a dealer identifier, or anonymously through another automated trading system, is useful in these circumstances and should be considered.
Investor relations and public relations

The bidder should prepare to “manage” the process in the press as well as with regulators and target shareholders. This can be very important where there is a competing bid or defensive moves on the part of the target or where the target is a “strategic asset” and the regulatory approval process will be critical to the transaction’s success.

Bear hugs

A “bear hug” involves a direct but forceful approach to a target, in which the prospective acquiror states its desire to negotiate a “friendly” deal while making it clear that the target’s interests could be negatively affected by a failure to respond. This aggressive manoeuvre can be effective, but it must be carefully calibrated to the circumstances.

The prospective acquiror may want or have to make a public announcement. In all cases, the prospective acquiror must be prepared for the target to do so before it has made its approach. Otherwise the target may announce and the stock price may run up, or other defensive steps may be taken, while the unprepared prospective acquiror attempts to get its announcement and bid out.

Lock-up and voting agreements

A bidder may enter a lock-up or voting agreement with the principal shareholder or other shareholders of the target, with the target’s board or with its management. Under such an agreement, the bidder will generally obtain the agreement of the shareholder(s) to deposit their shares into the bid and/or vote in favour of the transaction, as applicable. The agreement may be irrevocable or it may be subject to negotiated withdrawal rights in the event of a superior competing offer. A bidder must bear in mind (i) that executed lock-up and voting agreements are customarily filed with Canadian securities regulators and may trigger early warning disclosure obligations and (ii) that if the target has a shareholder rights plan (or poison pill), a lock-up or voting agreement may not be a viable alternative above the triggering threshold.

Pre-acquisition “support” agreements

Pre-acquisition “support” agreements can be used in both friendly and hostile acquisitions. They can occur in a merger (typically by way of an amalgamation or a plan of arrangement, in which some form of agreement with the target is a practical necessity) or in a take-over bid. In a hostile situation, a support agreement might be drawn up between an original hostile bidder and the target (in return for increased consideration, for example) or between a “white knight” and the target.
Common “key” terms in a support agreement

The following are among the terms most frequently negotiated in a support agreement:

- **Agreement to carry on business as usual** – The target agrees to carry on business in the ordinary course, advise of changes, etc.;

- **Agreement to complete** – The parties agree to complete the transaction, subject to negotiated conditions (in a take-over bid, the target board can obviously only agree to recommend the bid to shareholders). The target agrees to waive its shareholder rights plan, if applicable (this may be a delayed waiver);

- **Agreement to co-operate on deal mechanics** – The parties agree to exchange drafts of documents, and to co-operate on disclosure, regulatory or third party consents or approvals, acquisition of 100% of the target’s shares in a two-step transaction, stock options, tax-motivated or other reorganizations, etc. The target agrees to provide the bidder with the shareholders’ list as well as with access to information, premises, personnel, accountants, lawyers, advisors, etc. The parties will also have to agree about who pays what expenses;

- **Reps and warranties** – The bidder’s representations and warranties will be limited unless it is offering securities as part of its consideration. The target’s representations and warranties are generally of limited value post-closing, but may give the bidder walk-away rights if they are found to be materially incorrect before closing;

- **Target to mail out circular** – The target agrees to prepare and mail an information circular for the “merger” or, in the case of a bid, to mail the directors’ circular with the bidder’s take-over bid if requested;

- **D&O insurance** – The target is permitted to buy a run off policy for the target directors for up to six years, or (if not available) the bidder agrees to maintain directors’ and officers’ liability insurance for the target directors for up to six years; and

- **Honouring existing employment obligations** – The bidder agrees to honour employment obligations.

“Key” support agreement terms that are generally heavily negotiated and may be contentious

The following terms will often be negotiated as well, but they are generally much more contentious:

- **Break fees, expense reimbursements, etc.** – The target agrees to expense reimbursement and/or “hello”, break, or topping fees (see below);

- **Go shop** – If an auction has not occurred, the target may seek a short window following signing to do a market canvass for other bidders, after which the amount of the Break Fee would ratchet up;

- **Liquidated damages** – The parties may agree that the target will pay liquidated damages (i.e. a predetermined amount) to the bidder should the target breach the agreement;
• **Make-up of board or corporate officers** – The make-up of the target's board or its corporate officers might be agreed in advance, particularly in a share-for-share deal;

• **No-shop (with fiduciary out)** – The target agrees not to directly or indirectly solicit other competing offers or transactions, or provide information to others. This will generally be accompanied with a fiduciary out, but the out may be restricted (e.g. it may require financial advisory input, a written proposal at a higher price that is fully financed, etc.);

• **Reverse break fee** – The bidder agrees to pay the target a break fee if it fails to close due to certain conditions, such as a regulatory approval required to be obtained by the bidder or for a failure of the bidder to close on its financing;

• **Right to match** – The bidder may be given a right of first refusal for a limited period of time to match other competing offers;

• **Specific performance** – The ability of the target to apply to a court for the equitable remedy of specific performance if the bidder breaches the agreement and refuses to close;

• **Target standstill** – The target agrees to immediately cease any other negotiations, and perhaps to “call in” all information previously provided. The target might also agree to advise the bidder of any other proposals, including terms and sources;

• **Termination rights** – Termination rights may be based on time, failure to achieve required shareholder support and/or regulatory approvals, breach of agreement by other party, failure to satisfy closing conditions, etc.; and

• **Waiver of standstills** – Whether the target will be entitled to waive existing standstills in favour of other potential bidders.

**Break and topping fees**

A break fee is a fee paid to a prospective acquiror where its bid has failed for any of a list of specified reasons. The amount to be paid is usually a percentage of the deal’s equity value. A topping fee is similar but is based on the amount by which the bidder’s bid was exceeded by the rival successful bid.

Break and topping fees vary not only according to amount but according to the events that trigger the obligation to pay them. A common form of break fee is one that is triggered by one or more target-related events, e.g.:

- the acceptance of a competing transaction;
- the withdrawal of the target board’s recommendation; or
- the target board’s failure to promptly affirm its recommendation following announcement of another competing offer.

While break fees are common, it is clear that there are limits to the size of break fee that Canadian securities and corporate law (and Canadian securities regulatory authorities) will tolerate. The permitted size of payment has not been litigated in Canada, but the total of all fees typically ranges from 1% to 4.5% of a deal’s equity value, and most typically is between 2% and 4%. Institutional shareholders have
become vocal in criticizing break fees in the 3%+ range and have indicated that they may vote against transactions that include them, creating some downward pressure on the fee levels. A break or topping fee at the higher end of the range may be harder to justify if the company has not been “shopped”.

Reverse break fees

In private equity deals, it is relatively common to include a “reverse break fee” provision that requires the buyer to pay a fee if the transaction is terminated for certain reasons, such as a buyer’s failure to perform or failure to close on the buyer’s financing. The size of the fee varies, but is often similar to or greater than the “break fee”. In addition, reverse break fees for the failure to obtain regulatory approvals have become more common in recent years in Canada.

Expense reimbursement

Reasonable arm’s length expense reimbursement of the target to the bidder seems difficult to challenge, although the issue has not been litigated in Canada. Often the triggering event is simple failure to receive required shareholder approval/tender absent a competing transaction.

Shareholder rights plans (“poison pills”)

Shareholder rights plans (or “poison pills”) typically give a target’s shareholders, other than acquirors, the right to acquire shares in the target at a substantial discount. This right is typically triggered when an acquiror (such as a hostile bidder) acquires a significant stake – usually 20% or more on a partially diluted basis. Generally, the board of directors has the right to waive the application of the rights plan to a take-over bid made by means of a take-over bid circular to all shareholders. Under some plans, it may waive the application of the rights plan to an amalgamation, arrangement or other statutory procedure approved by the board and requiring shareholder approval. Typically, only shareholders may waive or terminate the application of the rights plan before its expiry in other circumstances.

Permitted bids and “chewable” pills

Historically, Canadian shareholder rights plans have typically allowed for a “permitted bid” in order to ensure that the target is not shielded indefinitely from a hostile bid. In keeping with the “pill” metaphor, such rights plans are often described as “chewable”. A permitted bid was typically defined as a bid made to all shareholders that remained open for a specified period (e.g. 60 days) and which was conditional upon acceptance by unrelated shareholders holding more than 50% of the shares not owned by the bidder (or related parties). As a result of recent amendments to the take-over bid rules, NI 62-104 now requires that more than 50% of the securities of the target held by independent shareholders be tendered to the bid and that the bid remain open for at least 105-days. Given these new amendments, all issuers are effectively given the benefit of statutory “permitted bid”
requirements. As such, the utility of shareholder rights plans on a go forward basis may be diminished. Despite this, in considering a toe hold or in structuring a potential acquisition (including considering lock-up agreements), a bidder should review and consider the specific terms and conditions of any shareholder rights plan of the target that is in place or plan for one that may be put in place (and in the case of an unsolicited bid, consider making a permitted bid under the terms of the shareholder rights plan).

Regulatory standards: National Policy 62-202, TSX and ISS

National Policy 62-202 “Take-Over Bids – Defensive Tactics” states that “the primary objective of the take-over bid provisions of Canadian securities legislation is the protection of the bona fide interests of the shareholders of the target company.” Rather than setting out a specific code of conduct, the Policy simply states that shareholder rights plans may come under scrutiny where they “are likely to deny or limit severely the ability of shareholders to respond to a take-over bid or a competing bid”\(^2\). In addition to NP 62-202, there is a TSX requirement that shareholders approve any new shareholder rights plan within 6 months of adoption. Also influential are the analyses conducted by Institutional Shareholder Services (“ISS”). ISS conducts a formal review process of shareholder rights plans proposed by Canadian public companies, either rejecting them or providing a “neutral” (that is, favourable) rating for the guidance of institutional investors. The result of these various rules and standards has been to make Canadian shareholder rights plans uniform, inflexible and relatively benign, on average, relative to U.S. rights plans.

Tactical shareholder rights plans

There are some significant practical distinctions between long-term shareholder rights plans and “tactical” poison pills that are intended to respond to a particular unsolicited bid. Because tactical pills are expected to be short-lived, they are less constrained by concerns about shareholder approval (which, as noted above, is required only within 6 months) or obtaining a favourable ISS rating. Tactical poison pills will therefore generally grant target boards broader latitude to accept or reject a bid.

Canada’s traditional approach: tight time limits on tactical pills

Opponents of a Canadian tactical pill can, and often do, contest them before the appropriate provincial securities regulator. Upon an application for a “cease-trade” order deactivating the rights under the plan, the regulator will hold a hearing, the result of which until recently has usually been (with few exceptions) an order cease-trading the tactical pill once it has served its function of giving the board “breathing room” to evaluate the situation and, where appropriate, to seek out other bids. The

\(^2\) National Policy 62-202 – Take-Over Bids – Defensive Tactics, 20 OSCB 3525, ss. 1.1(2), (4) and (5).
typical lifespan of a Canadian tactical poison pill has therefore been 45 to 75 days after the launching of a bid. Given this regulatory approach, a “just say no” response has traditionally been considered a non-starter in Canada. In light of recent amendments to the take-over bid rules, which now require bids to remain open for at least 105-days (subject to the target shortening such period), it will be interesting to see how issuers and regulators address tactical pills.

**Other Pre-Bid/Pre-Approach Considerations**

**Tax and accounting issues**

Tax and accounting issues will vary greatly from situation to situation, but they should always be thought through prior to launching an offer of any kind. As noted above, unless they obtain specific relief, non-Canadian companies offering securities may be required to reconcile or conform their financial statements, MD&A, and auditors’ reports to IFRS.

**MJDS and other U.S. and foreign law issues**

Where a contemplated transaction would have a cross-border component, it is important to consider the requirements of non-Canadian jurisdiction. The Canada-U.S. multi-jurisdictional disclosure system (MJDS) provides that an eligible take-over bid made in compliance with Canadian requirements will generally also comply with U.S. federal requirements by filing a “wrapper” to go around the Canadian document, although U.S. disclosure rules may apply to a subsequent business combination (i.e. what was formerly called a “going private transaction”).

Eligibility requirements for MJDS include:

- A limit of 40% for holdings of class of target’s shares held by U.S. holders;
- The target’s being incorporated in Canada and being a “foreign private issuer”;
- Compliance with Canadian requirements (or acceptability to the SEC of minor exemptions); and
- Terms applicable to U.S. holders being no less favourable than those applicable to Canadian holders.

A court-approved arrangement may provide a section 3(a)(10) exemption for the issuance of share consideration under U.S. securities law and avoid material SEC review of a registration statement.

Where the contemplated transaction has other foreign components, it will be critical to ensure compliance with all applicable legal and regulatory requirements.
### Sample Timeline for Responding to an Unsolicited Bid (105-Days)

<table>
<thead>
<tr>
<th>Event Description</th>
<th>Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Create working group</td>
<td>1-3</td>
</tr>
<tr>
<td>Create legal / financial advisor teams</td>
<td>1-3</td>
</tr>
<tr>
<td>Co-ordinate communications strategy</td>
<td>1-3</td>
</tr>
<tr>
<td>Assemble information that directors will require to respond. See Table A, below.</td>
<td></td>
</tr>
<tr>
<td>Establish a data room</td>
<td></td>
</tr>
<tr>
<td>Seek to have “white knights” sign confidentiality/standstill agreements</td>
<td></td>
</tr>
<tr>
<td>1st board meeting – agenda outlined in Table B, below.</td>
<td></td>
</tr>
<tr>
<td>Provide shareholder list to bidder (if not already provided)</td>
<td></td>
</tr>
<tr>
<td>Complete data collection for directors</td>
<td></td>
</tr>
<tr>
<td>Due diligence performed by financial advisors</td>
<td></td>
</tr>
<tr>
<td>Begin preliminary analysis of alternatives, including possibly adopting tactical</td>
<td></td>
</tr>
<tr>
<td>poison pill</td>
<td></td>
</tr>
<tr>
<td>1st board meeting – agenda outlined in Table B, below.</td>
<td></td>
</tr>
<tr>
<td>2nd board meeting (about Day 8) – agenda outlined in Table B, below.</td>
<td></td>
</tr>
<tr>
<td>3rd board meeting – agenda outlined in Table B, below.</td>
<td>14-15</td>
</tr>
<tr>
<td>Mail directors’ circular (not later than Day 15)</td>
<td></td>
</tr>
<tr>
<td>Last day for directors to issue recommendation on the bid</td>
<td>98</td>
</tr>
<tr>
<td>Initial bid period expires</td>
<td>105</td>
</tr>
<tr>
<td>Mandatory 10-day extension period expires. Bid expires unless extended.</td>
<td>115</td>
</tr>
</tbody>
</table>

Please refer to Tables A and B, below, for a more complete explanation of certain items in the timeline. The details of actual unsolicited bid responses will vary. The process will sometimes be extended well beyond the 35-day minimum assumed here.
### Table A: Information Required for Directors’ Response (Days 1 to 3)

<table>
<thead>
<tr>
<th>Management</th>
<th>Financial Advisors</th>
<th>Legal Counsel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management will provide the board with its views on a number of items:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Budgets and projections</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Financial position</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Business plans and future prospects</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Undervalued assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Whether a better price could be achieved later</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Impact on the company, employees, suppliers, customers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Tax issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial advisors will provide the board with the following:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Fairness or inadequacy opinion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Advice on state of market</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Advice on state of the economy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Advice on comparable acquisition premiums</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Potential for an auction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Alternatives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal counsel will provide the board with specific advice on the legal matters discussed in this booklet and other legal issues that may be particular to the situation, including alternatives.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Table B: Typical Agenda Items for Board Meetings (Days 1 to 15)

<table>
<thead>
<tr>
<th>First Meeting</th>
<th>Second Meeting</th>
<th>Third Meeting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Organizational</strong></td>
<td><strong>Management</strong></td>
<td><strong>Further Updates</strong></td>
</tr>
<tr>
<td>Confirm membership of working group</td>
<td>Will report on the impact of the bid on their constituencies and on the communication program</td>
<td>Working group members will continue to keep the board informed</td>
</tr>
<tr>
<td><strong>Procedural</strong></td>
<td><strong>Financial Advisors</strong></td>
<td><strong>Finalizing Directors' Circular</strong></td>
</tr>
<tr>
<td>Legal counsel will review the fiduciary duties of the board and the process to be followed to satisfy those duties</td>
<td>Will update the board on their review of the fairness or inadequacy of the bid, and on alternatives</td>
<td>The directors’ circular will usually be finalized for mailing on Day 15 at the latest</td>
</tr>
<tr>
<td><strong>Informational</strong></td>
<td><strong>Legal Counsel</strong></td>
<td></td>
</tr>
<tr>
<td>If possible, the members of the working group will provide their preliminary views with respect to the bidder, the terms of the bid, the legality of the bid, and the role of the shareholders’ rights plan (if there is one – otherwise they will consider implementing one)</td>
<td>Will review the legality of the bid, areas for litigation (if any) or other defences, and provide an update on the shareholder rights plan, if there is one</td>
<td></td>
</tr>
<tr>
<td><strong>Instructional</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The board will instruct the working group to collect data, review alternatives, establish a timetable for reporting, and consider the appropriate responses to key constituencies</td>
<td>The board will then instruct the working group members on some or all of the following, if appropriate:</td>
<td></td>
</tr>
<tr>
<td>• Litigation</td>
<td>• Continuing analysis of other alternatives</td>
<td></td>
</tr>
<tr>
<td>• Other initiatives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A draft of the directors’ circular will also be reviewed at this time</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Tables A and B refer to the Sample Timeline that precedes them. They are intended to illustrate the issues most commonly encountered in formulating a response to a take-over bid. Other more situation-specific issues will typically need to be dealt with as well.
M&A in Canada: Duties of the Target Board

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Duties of the Target Board

This discussion provides a general overview of the duties of directors of a target board when faced with the prospect of a change of control transaction. The target board’s response to a bid, whether friendly or hostile, demands close attention to the legal requirements, which are generally consistent across Canada.

Fundamental Duties of Directors

In Canada, corporate board members generally have three fundamental statutory duties:

- a duty to manage or supervise the management of the corporation;
- a duty of care; and
- a duty of loyalty (fiduciary duty).

Duty to Manage the Corporation

The duty to manage or supervise the management of the corporation is the director’s most fundamental duty. While day-to-day management tasks can be delegated to professional managers, the directors retain responsibility for the overall direction of the corporation (unless some or all of the board’s powers have been transferred to the corporation’s shareholders under a unanimous shareholders or equivalent agreement). In managing the corporation, directors have an obligation to inform themselves fully of all material information available on alternatives for the corporation and chart a course for the corporation that is in its best interests. In the context of a proposed change of control transaction, the duty to manage translates, generally speaking, into a duty to stay on top of the process, while still supervising the management of the ongoing business of the corporation. While a board may—and should—obtain the advice of financial advisors with respect to the merits of any proposed transaction, each board member must fully familiarize himself or herself with all reasonably accessible material information, while casting a critical eye on any advice received.

Duty of Care

Directors have a duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. While the Supreme Court of Canada indicated in Peoples Department Stores (Trustee of) v. Wise, [2004] 3 S.C.R. 461, (2004), 244 D.L.R. (4th) 564 (S.C.C.) that the standard is an objective one and that a director’s actions will not be judged with the perfect vision of hindsight, a cautious view is that Canadian courts are likely to impose a higher standard of care on directors who have specialized knowledge or are particularly sophisticated.
Generally speaking, to satisfy the duty of care, directors must be in a position to
demonstrate that their decision-making was properly informed and fully
considered. As a practical matter, the courts are reluctant to substitute their own
business judgment for that of directors who have acted honestly, prudently and in
good faith. Canadian courts (like their U.S. counterparts) will, however, scrutinize
the process by which the directors make their decisions and the apparent objectives
of their actions. Both Canadian and American courts have tended to examine the
degree of formality adopted by directors in deliberating over a potential transaction.
Good corporate governance arrangements will therefore generally serve as “a shield
that protects directors from allegations that they have breached their duty of care”
(Peoples).

In order to avoid potential liability for a breach of the duty of care, directors should:

- exercise reasonable diligence in gathering the necessary material information
  required to reach an informed decision;
- acquaint themselves with the relevant facts and engage in an active, careful
deliberation before making a final decision;
- read and understand material that is tabled prior to a meeting, including
  (where available) advance copies, drafts or summaries of key documents;
- ask probing questions and avoid undue haste;
- promptly register a dissent if a director concludes that the corporation is
  pursuing an improper course of action;
- seek the advice of credible financial advisors where appropriate, while taking
care not to rely on such advice in an uncritical manner. As noted above, a higher
standard of care may be expected of persons who, by nature of their
professions, are well versed and sophisticated in corporate procedures; and
- take proactive steps to identify and respond to any actual or potential conflicts
  of interest when evaluating a potential change of control transaction.

It is essential to document the board’s decision making process fully. Legal and
financial advisors will be of assistance in this area.

**Fiduciary Duty (Duty of Loyalty)**

In managing the affairs of a corporation, directors have a fiduciary duty to act
honestly and in good faith with a view to the best interests of the corporation. In
carrying out his or her function, it is the director’s duty to pursue the corporation’s
interest diligently and to the exclusion of any competing interest, including the
director’s personal interest (to the extent that there is a conflict). This requires full
disclosure of a director’s dealings with the corporation and the avoidance of all
possible material conflicts of interest between the director and the corporation with
respect to the transactions in which the corporation is involved.

While the fiduciary duty of directors is owed to the corporation and not to any
individual group of corporate stakeholders, the Supreme Court of Canada
recognized in *BCE v. 1976 Debentureholders, 2008 SCC 69*, that, even when they are
taken with a view to promoting the corporation’s interest, board decisions may incidentally benefit some corporate constituencies more than others. In BCE, the court stated that boards may take into account the “ancillary interests” of shareholders, employees, creditors and others as they deliberate about what is in the “best interests of the corporation”, and should be accorded deference under the business judgment rule where they choose to do so.

While the Supreme Court’s view in BCE may appear difficult to reconcile with the view that the fiduciary duty is owed only to the corporation, it is largely understood to mean that in determining what is in the best interests of the corporation, the directors may be obliged to consider the impact of their decisions on other stakeholders given the reasonable expectations of such stakeholders. Regardless, the interests of the corporation are nevertheless paramount, as the duty is owed to the corporation, not to its stakeholders. Provided that the directors consider the interests of stakeholders and make a decision that is reasonable in light of conflicting interests, the court will not generally question whether the decision of the directors was perfect. It is only where directors do not satisfy the reasonable expectations of the shareholders that they will act in the best interests of the corporation and where the behaviour of the directors is oppressive, is unfairly prejudicial, or unfairly disregards relevant interests that stakeholders can legitimately claim that the directors breached their fiduciary duty.

**Applicability of Revlon Principles**

It is often asked how Canadian law in this area compares with that of the U.S., and specifically with Delaware’s “Revlon” test (Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985)), which is sometimes described as requiring the board to take on the role of “auctioneers” in a change of control situation. In other words, Delaware courts have generally supported the proposition that, once a change in control has become inevitable, the directors’ overriding duty is to maximize shareholder value. The Revlon duty was subsequently recast in Paramount Communications v. Time 571 A.2d 1140 (Del. 1989) as a duty to seek the best value reasonably available to shareholders in the circumstances. This is a more flexible standard, which recognizes that the particular circumstances are important in determining the best transaction available, and that a board is not limited to considering only the amount of cash or consideration involved.

The Revlon duty has not been adopted in Canada. In BCE, the Supreme Court of Canada rejected the Revlon duty to maximize shareholder value in a change of control situation in favour of a duty to consider the interests of the corporation. This is not to say that Canadian courts will not be informed by Revlon or that directors who seek to maximize shareholder value in response to a contested bid will not have discharged their fiduciary duties. Rather, BCE represents a reaffirmation of directors’ duties as a function of the business judgment rule; as the duty is to the corporation, the directors ultimately must decide what is in the best interests of the corporation in the particular situation it faces. As discussed above, the test as
enunciated in BCE, is more aptly described as looking at whether the directors identified the reasonable expectations of stakeholders and ensured that they were not unfairly disregarded. Realistically, however, in the case of a solvent corporation, we can expect courts to be most interested in shareholders, as the owners of the business.

It might be said, however, that from the perspective of fiduciary duty, courts in the major U.S. and Canadian jurisdictions are similar in allowing the board a degree of leeway in deciding what is best for the corporation. On both sides of the border, the courts have been clear that each particular situation must be carefully considered on its own merits.

The board’s fiduciary duties in a change of control situation must also be considered in light of National Instrument 62-104 - Take-Over Bids and Issuer Bids adopted by the Canadian securities regulators, as discussed in Chapter C of M&A in Canada, “Acquiring a Public Company”.

Further Considerations

**Oppression**

Under most Canadian business corporations statutes, corporations and their directors and controlling shareholders (among others) can be liable for actions that are “oppressive or unfair prejudicial” to the interests of any of a wide range of stakeholders, including shareholders and creditors.

Interests protected by the “oppression remedy” are those that the complainant could reasonably have expected the corporation to protect. For this reason, the concept of “reasonable expectations” is key to any analysis of the oppression remedy. This is a quasi-equitable remedy that can take the form of an order setting aside transactions or contracts or an order replacing all or part of the board, among other (virtually limitless) possibilities. Because of its significant flexibility, the oppression remedy has become a popular tool for disgruntled shareholders, creditors and others seeking redress against Canadian corporations.

In particular, oppression is often pleaded in cases involving board decision-making. In BCE, the board was found to have a duty, based partly on the fiduciary duty and partly on the oppression remedy, to consider the interests of the corporation’s debentureholders. Ignoring their interests altogether, the Supreme Court of Canada held, could constitute “unfair disregard” (although not found by the court in this case) under the oppression provision. Some guidance may be taken from a number of the factors that the Supreme Court identified as having influenced its deliberations on the “reasonable expectations” issue in BCE, e.g.: (i) that the actions complained of were common commercial practice, (ii) that the debentureholders’ complaint could have been avoided by negotiating protections in the trust indentures, (iii) that the corporation in question was large, and (iv) that no
representations had been made that created expectations on which the debentureholders could have reasonably relied.

**Business Judgment Rule**

Adapted from U.S. case law, the “business judgment” rule calls for judicial deference to business decisions of boards of directors, even if in hindsight they were not the best possible decisions. In other words, the business judgment rule provides that the courts will not usurp the board’s function in managing the corporation in the absence of evidence of fraud, overreaching, illegality, or conflict of interest. If business decisions have been made honestly, prudently, in good faith and on reasonable and rational grounds, the courts will decline to substitute their own opinion for that of the board, even where subsequent events may cast doubt on the board’s determination.

In contrast to their apparent reluctance to import the *Revlon* rule into Canada, Canadian courts have strongly endorsed the business judgment concept. In particular, as noted above, the Supreme Court of Canada in *BCE* made it clear that, in a change of control situation, the decision about how best to promote the best interests of the corporation is a “function of business judgment.” In general, the Supreme Court seems to have taken the view in *BCE* that where a company is in play (i.e. where a transfer of voting control is “inevitable”), Canadian courts should not second-guess the board’s decision provided that it is “within the range of reasonable choices that they could have made in weighing conflicting interests”, this determination being partly dependent on the reasonable expectations of the various corporate constituents. While there is a requirement to inform oneself about the interests at play, that requirement was satisfied in the circumstances of *BCE* even though no action had been taken in consequence of the board’s consideration of the debentureholders’ complaints.

The *CW Shareholdings Inc. v. WIC Western International Communications Inc.* (1998), 39 O.R. (3d) 755 (Ont. Gen. Div.) and *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 40 B.L.R. (2d) 244 (Ont. Gen. Div.), aff’d (1998), 42 O.R. (3d) 177 (C.A.) cases are examples of how the rule can be applied in the context of a proposed change of control transaction. In each of these rulings, the Ontario courts held that as the directors had taken steps to maximize shareholder value that were reasonable in the circumstances, they were not in breach of their fiduciary duties. These cases provide valuable examples of the steps that may be reasonable, depending on the circumstances. Although these cases apply a different approach than the “enhanced scrutiny” or *Unocal* test (after the case in which it originated, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)), both approaches have common requirements in that the court must be satisfied that the directors have acted reasonably and fairly.

The business judgment rule does not give boards unfettered discretion, however. In particular, their decisions should, at a minimum, involve genuine deliberation. In
Ford Motor Co. of Canada Ltd. v. OMERS (2006), 79 O.R. (3d) 81 (C.A.), Ontario's Court of Appeal found that the board of the U.S. automaker's majority-owned Canadian subsidiary had essentially rubber-stamped a transfer-pricing arrangement (and other inter-company pricing arrangements) recommended by the 94% U.S. majority shareholder. Under such circumstances, the business judgment rule could not be successfully raised in the company's defence against the 6% minority's argument that the inter-company arrangements had artificially depressed Ford of Canada's value and, as a consequence, the price they received when the company was taken private. Whether this is characterized as a failure of process or a failure to act reasonably, the message is essentially the same: a board may have difficulty in invoking the business judgment rule where it has not actively exercised its judgment at all.

Defensive Tactics

Where a board reasonably concludes that a proposed transaction is not in the best interests of the corporation, or is inadequate or unfair to shareholders, or that measures are required or desirable to improve value to shareholders, the board may conclude that various “defensive” tactics are warranted. Defensive tactics can entrench the position of management or directors by deterring bidders, and the range of tactics available to directors varies widely. They may include: inducing alternative value maximizing transactions (such as by courting a white knight, commencing an issuer bid, recapitalizing, issuing a special dividend, or inducing a higher offer with break fees, expense reimbursements, asset lock ups or asset exchanges), buying more time for the target (such as by commencing litigation, waging a public relations war, implementing a “just say no” defense, using political or regulatory interference, using a tactical shareholder rights plan or “poison pill”, or by denying data room access to the bidder), making the target less desirable, or frustrating the hostile bid (such as by selling off crown assets, issuing shares, or granting so-called “golden parachutes”). Consequently, securities regulators and courts will frequently examine defensive tactics to ensure that directors have engaged in a manner that is consistent with their duties.

Regardless of the approach taken, Canadian courts are unlikely to uphold defensive tactics against an unfriendly approach if they have the purpose or effect of enabling management or director self-entrenchment (although the fact that directors acting in good faith and consistently with their fiduciary duties happen to benefit personally from a decision is not typically fatal to that decision).

Securities Regulation and Defensive Tactics

National Policy 62-202 Take-Over Bids – Defensive Tactics (NP 62-202) sets out the general views of Canadian securities regulators on defensive tactics adopted by target directors in response to take-over bids. As discussed below, there is a certain
tension between NP 62-202 and the Supreme Court of Canada’s reasoning in *BCE* when it comes to defensive tactics. The philosophy of NP 62-202 is that:

- the appropriate regulatory approach to take-over bids is to encourage unrestricted auctions;
- target corporation shareholders have the right to make the take-over bid decision, and target directors have no valid reason to (unilaterally) deny the shareholders that right; and
- specific rules for regulating target directors, other than those imposed by corporate law, are inappropriate.

NP 62-202 does not specify a fixed code of conduct for directors nor does it attempt to specify proper or improper defensive tactics. It does, however, set out some presumptions as to what may be proper or improper responses to a take-over bid, and indicates that:

- prior shareholder approval might allay concerns that a tactic is abusive;
- the timing of the tactic may be relevant—regulatory scrutiny may be attracted when conduct occurs during the course of a bid (or immediately prior to a bid if the target board has reason to believe that a bid is imminent); and
- certain listed defensive tactics may activate regulatory scrutiny, including share and asset lock-ups, asset purchases, and actions taken outside the ordinary course of business.

NP 62-202 suggests that securities regulators are less likely to intervene where target directors act to maximize shareholder value. The policy goes further than corporate law in potentially constraining possible target director conduct in that the emphasis is undeniably on shareholder interests. As well, directors’ motivations can become irrelevant. Instead, the policy focuses on the results of the target directors’ actions and any activity that denies or severely limits the target shareholders’ access to a take-over bid may lead securities regulators to intervene. Taking this result-oriented approach means that regulators may interfere notwithstanding director compliance with fiduciary duties.¹ For example, in *Petaquilla Minerals* [2012] BCSECCOM 442, the British Columbia Securities Commission cease-traded a rights plan (also known as a “poison pill”) and a private placement while acknowledging that the private placement was not a “purely defensive measure”, and in *AbitibiBowater inc. (Produits forestiers Résolu) c. Fibrek Inc.*, 2012 QCBD 8, the Quebec Bureau de la décision et de la révision en valeurs mobilières cease-traded a rights plan and private placement to a white knight notwithstanding that the white knight’s bid represented a significant premium to what was originally offered by the hostile bidder (who was ultimately successful). However, more recently in *Hecla Mining* [2016] BCSECCOM 359, 39 OSCB 8927, both the British Columbia Securities Commission and the Ontario Securities Commission upheld a private placement undertaken by a target of an unsolicited take-over bid where it was concluded that the private placement was not implemented as a defensive tactic and that there was

a legitimate need for the financing. In reaching their joint decision, the BCSC and OSC contrasted private placements with shareholder rights plans, acknowledging that private placements may serve multiple corporate objectives, and established that targets will have the onus of establishing that a private placement is not being used as a defensive tactic.

In relation to shareholder rights plans or “poison pills”, Canadian securities regulators under NP 62-202 have historically taken the approach that it is not a question of “if” a shareholder rights plan will be cease traded by the securities regulators, but rather it is a question as to “when” a shareholder rights plan will be cease traded when there is an outstanding take-over bid for the target company’s securities. Generally, securities regulators in Canada have allowed a shareholder rights plan to remain operative for 45-75 days in the face of an outstanding take-over bid in order to allow the target board of directors to seek value-maximizing alternatives to the take-over bid. If there seems to be little likelihood that a superior alternative will arise for the target, shareholder rights plans have generally been cease traded to allow for the target’s shareholders to decide whether or not to tender to the bid.

In 2016, Canadian securities regulators made amendments to the take-over bid regime that included, among other things, requiring take-over bids to remain open for 105 days (up from the previous 35-day minimum deposit period), subject to certain exceptions. As a result of the take-over bid amendments, it is likely that shareholder rights plans will become less relevant in the context of hostile take-over bids, but they do remain relevant to prevent certain pre- or post-hostile bid actions which may inhibit a value-maximizing process. For instance, they may still be effective to restrict a creeping take-over bid, to limit the use of the private agreement exemption by the bidder and also restrict the ability of bidder to enter into lock-up agreements. A target company may adopt a rights plan in advance of the 105 day expiry date of a hostile bid in an effort to buy more time, but this tactic is likely to be proved unsuccessful by securities regulators cease trading such rights plans and, at a minimum, the target will have a heavy burden to prove that a value maximizing alternative is imminent to justify a rights plan staying in place past 105 days. Target boards may also adopt rights plans in the face of a hostile bid and seek shareholder approval. If shareholders approve such a pill, it remains to be seen how the Canadian securities regulators will react.

Canadian securities regulators have reminded capital market participants of the continued applicability of NP 62-202 and that they will be prepared to examine the actions of target boards in specific cases, and in light of the take-over bid regime, to determine whether they are abusive of shareholder rights. They have also commented that a transaction initiated by a target board in the context of a take-over bid may still be subject to review under NP 62-202, regardless of whether or not it is an “alternative transaction” (as defined in the take-over bid rules).
Independent Committees

The appointment of an independent committee (or special committee) of directors is a typical method of protecting a board from potential conflicts of interest with respect to review of a proposed take-over. Where a board makes a decision based on the recommendation of an independent committee, that decision will generally be given a measure of deference by the courts, provided that the independent committee has discharged its role independently, in good faith, on reasonable grounds.

In some circumstances, an independent committee is a requirement. The Ontario Securities Commission, pursuant to Multilateral Instrument 61-101 - Protection of Minority Shareholders in Special Transactions (MI 61-101), requires the establishment of an independent committee in the context of insider bids, and recommends them in certain other types of transactions (related-party transactions, business combinations and issuer bids). In the context of a take-over bid for a company with a controlling shareholder, it would also be prudent to establish an independent committee, in order to demonstrate that the process followed by the directors was fair, free from conflicts of interests and sufficient to discharge the duties owed by the directors to the company.

Where an independent committee is either mandated or recommended, the directors are advised to adhere to the following procedures and guidelines:

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Procedures of the Board and Special Committee

The Board and Special Committee should establish and adhere to a set of guidelines that complies with the letter and spirit of the law, as well as with current best practices. Although every situation will need to be assessed according to its unique facts, the following are examples of items that would typically appear in such guidelines.

Compensation

MI 61-101 expressly prohibits independent directors from receiving payments or benefits that are contingent on the completion of a transaction. As a general rule, compensation should be set out in advance of deliberations to minimize potential conflicts of interest.

Clear and Unambiguous Mandate

The independent committee should have a clear, written mandate embodied in resolutions adopted by the Board. In addition, the independent committee needs to have the authority to discharge its mandate.

Informed, Deliberative Process

The directors should inform themselves fully of all material information reasonably available prior to approving a definite agreement or giving a recommendation on any proposed transaction (whether or not a change of control transaction). Complying with due diligence procedures and undertaking...
discussions with both management and the advisors as to the relative merits and
demerits of the proposed transaction and their methodology will ensure that an
informed decision is arrived at.

Use of Investment Bankers and Other Advisors
The Board and any special committee may rely on financial advisors who would
assist them in evaluating any proposed transaction from a financial point of view,
in considering alternative courses of action open to the company or in the
preparation of documentation necessary to create the required evidence. For
purposes of determining whether to recommend any change of control
transaction being put to the shareholders, the board should obtain a publishable
opinion from its financial advisors as to the fairness of the consideration
receivable under the transaction.

The following points should be borne in mind:

• U.S. courts have chastised boards of directors and independent committees
  for failing to seek expert advice in a number of cases involving change of
  control transactions. They have also shown a marked reluctance to second-
guess the business judgment of directors in cases where the integrity and
  probity of the decision-making process has been demonstrated. However, the
  board and any special committee may not unquestioningly rely on the advice
  of its advisors. The general duty of care requires that the directors diligently
  review and question such advice.

• U.S. courts have censured directors and independent committees for reliance
  upon the advice of advisors, such as investment bankers, where the advice in
  question was not sufficiently independent of both the corporation and the other
  parties to the change of control transaction to provide conflict-free advice.

• While BCE and other cases have confirmed the value of fairness opinions
  from “reputable experts”, the OSC has stated, in obiter dicta in its 2009 ruling
  in Re HudBay Minerals Inc., 32 O.S.C.B. 3733, that where an advisor “is being
  paid a signing fee or a success fee” the resulting fairness opinion does not
  assist directors on an independent or special committee in demonstrating that
  they have taken due care. While, as noted, this is only an “obiter” view, and
  despite the fact that the OSC stated in the same place that it does not
currently “regulate the preparation or use of fairness opinions”, its statement in
HudBay has been taken by many as an indication of how the Commission
might possibly rule were the “success fee” issue to be brought before it. As a
result, obtaining a “fixed fee” (or an additional) fairness opinion is emerging as
a best practice.

• As an addendum to the point above, it should be noted that stapled financing,
in which the acquiror is offered a financing package sponsored by the
investment bank of the target, may also preclude meeting the independence
criterion where that bank is also providing the fairness opinion.
Documentation

Detailed minutes should be kept of all meetings of any special committee and the board. In addition, if particular directors have more extensive contacts with the financial advisors or third parties that are consulted with respect to any proposed transaction, such directors should keep written records of their discussions and inform other directors of the substance of such discussions.

Ensuring the independence of the independent committee is important. Its members should also be provided with the resources, information and access to management and advisors required to fulfil their mandate. It is important to remember that the basic duties of directors – the duty to manage, the duty of care and the duty of loyalty – continue to govern those who sit on a special committee.

Conflicts of Interest

The CW Shareholdings and Maple Leaf Foods decisions addressed conflicts of interest in the broader context of the composition and activities of independent committees, rather than the narrower context of business corporations legislation. In the first of these rulings, the Ontario court was critical of the fact that the President and CEO of the target company sat on the special committee, noting the leading role he played in negotiations with a rival bidder in a hotly contested take-over contest between two rival bidders. It held that his presence on the committee, and the role he played, were inconsistent with the independence expected of a special committee. Notwithstanding that, the court found as a matter of fact that the special committee had conducted itself in a fashion that enabled the directors to carry out their objective of maximizing shareholder value. The constitution of the committee would have represented a breach of the directors’ fiduciary duties only if it had had a detrimental effect on share value maximization.

In Maple Leaf Foods, the CEO and CFO of Schneider were both actively involved in negotiating with the bidders, though in this case neither belonged to the special committee. While recognizing the potential conflict of interest, the Court of Appeal for Ontario balanced the risk against the value of involving senior management, with its much superior understanding of Schneider’s operations, in the negotiations. The court found that, in the circumstances, it would have been unrealistic to expect the members of the special committee to negotiate directly with bidders.

The lesson is that the potential conflicts of interest inherent in holding a position such as CEO, CFO or other senior manager will not usually require that they sideline themselves during negotiations. However, in properly discharging its responsibilities, the board as a whole should be in a position to supervise the negotiations.
General Observations with Respect to Responses

Unsolicited Bid

In light of the duties discussed in this chapter, we can make some generalizations about how a target board might typically respond in the event of an unsolicited bid or offer.

Duty to Respond to a Take-Over Bid

Under Canadian securities law, if a formal take-over bid is made, directors of a corporation are required to prepare and deliver a directors’ circular to shareholders not later than 15 days from the date the bid is commenced. The directors’ circular must include a recommendation to accept or reject the bid, together with the reasons for the recommendation. It is also possible to state in the circular that the directors are unable to make a recommendation either way, provided the reasons for this are stated. An individual director may deliver a dissenting recommendation. A board may also decide to delay making a recommendation. In such a case, the board must advise shareholders that the board is considering the merits of a bid and that shareholders should not tender their shares until the board can make a recommendation one way or the other. The board must ultimately send a recommendation (or confirm that it will not make a recommendation) not later than 7 days before the scheduled expiry of the bid. In the event that a change occurs that will reasonably affect a shareholder’s decision to tender, the directors must issue a press release and send a notice of the change.

No Absolute Duty to Negotiate

There is no absolute duty to negotiate with a bidder, nor is there any general duty to sell a corporation if a bid is made. While it is possible that a Delaware-style “auctioneer” duty will continue to be found to apply in some situations, the prevailing view following the Supreme Court ruling in BCE, as discussed above, is that the strict Revlon duty is generally not applicable in Canada. However, where a change of control seems certain, a board will generally be acting reasonably if it chooses to move forward with a competitive bidding process.

Directors Must Take Steps to Inform Themselves

There are few hard and fast rules. A premium over market, for example, is not necessarily a fair price. One thing that is clear, however, is that directors, as fiduciaries, must be impartial and their response to an unsolicited bid or offer must be informed and careful. Directors need to make sure that they fully understand the value of the corporation and the factors that influence its value. This typically means using a financial advisor and legal counsel, but it can also mean retaining additional experts in specialized areas.
When Defensive Measures are Justified

Reasonable defensive measures may be justified if the directors conclude that a bid is inadequate or unfair and where they are likely to help elicit a better offer (although any proposed measure must be assessed in light of NP 62-202). Possible defensive measures are discussed above under the heading “Defensive Tactics”.

Friendly Approach

The general duties of directors apply in all situations. When faced with a friendly bid, directors of the target must continue to act in the best interests of the target company. In a negotiated transaction, this duty characteristically comes into play if (as is typically the case) the prospective acquiror wants the target to negotiate with it exclusively, rather than “shopping” its offer to other potential bidders or holding an auction. Since the shareholders of the target will want some assurance that the maximum value of their shares will be realized in the transaction, the directors of the target can be placed in a difficult position. This often leads them to take steps such as the following:

- The appointment of a special committee of independent directors mandated to assess the financial fairness of the take-over bid to shareholders, and any possible alternatives;
- Retaining a financial advisor to assess the take-over bid and to provide a fairness opinion and other financial advice;
- Attempting to negotiate a higher bid price; and/or
- In many cases, conducting an auction, either open or selective (this will usually involve opening a data room and soliciting buyers), or facilitating superior proposals via a “fiduciary out”.

As a general rule, a substantial benefit should be evident in order for a target board to pre-empt an auction process. Of course, if controlling or significant shareholders are “locked up” to the take-over bid, there may be no point in seeking alternatives.

Liability for Misrepresentations in Bid Documents

Canadian securities legislation creates potential liabilities for directors, officers and others connected with an issuer with respect to misrepresentations in take-over bid circulars, issuer bid circulars, directors’ circulars or director’s or officer’s circulars. There are a number of defences where a document was filed without the director or officer’s knowledge, where he or she withdrew consent on learning of the misrepresentation, where the misrepresentation was contained in an expert’s report that was reasonably relied on, etc.

It is important to note that, in most circumstances, reliance on any such misrepresentations does not need to be demonstrated, a fact that enhances the capacity of securityholders to proceed by way of class action.
M&A in Canada: Minority Shareholder Protections

Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* regulates the disclosure, valuation, review and approval processes for four types of transactions: insider bids, issuer bids, business combinations and related party transactions. Recognizing that these types of transactions can be abusive or unfair to the interests of minority shareholders (due to the voting power, board representation or informational or other advantage of an interested party), MI 61-101 attempts to ensure equal treatment of shareholders by imposing certain procedural safeguards, including enhanced disclosure requirements and, where applicable, independent valuations and majority of the minority security holder approval. Public companies in Canada are generally subject to MI 61-101.¹

**Insider Bids**

“Insider bids” are take-over bids proposed by one or more “insiders” of an issuer. These include bids made by an “issuer insider” (which includes a major shareholder (10% plus), or a director or senior officer of the target or of any person that is an issuer insider or a subsidiary entity of the target), any associated or affiliated entity of any such issuer insider or of the target itself, as well as any person who has been in any such relationship within the previous 12 months and any person that is a joint actor of any of the foregoing.

Subject to limited exceptions, the offeror in an insider bid must provide shareholders with a formal valuation prepared by an independent valuator at the offeror’s expense. An independent committee comprised of “independent” directors of the issuer must determine who the valuator in will be, supervise the preparation of the formal valuation and use its best efforts to ensure that the formal valuation is completed in a timely manner. The disclosure document that the offeror provides to shareholders must also provide information concerning “prior valuations,” being any formal valuation of the target within the previous 24 months, of which the offeror or any director or senior officer of the offeror has knowledge.

Directors of the target are also subject to a similar “prior valuation” disclosure requirement in the directors’ circular relating to the bid, as well as the requirement to disclose *bona fide* prior offers received by the issuer in the 24 months preceding public announcement of the bid. The exceptions from the formal valuation requirement include bids made on the terms of previous arm’s length negotiations or those made in the context of an auction, as well as circumstances where neither

¹ While MI 61-101 is a joint rule adopted only by the Ontario Securities Commission and the Autorité des marchés financiers in Quebec, it will generally apply to the majority of reporting issuers in Canada as issuers listed on the Toronto Stock Exchange, and the CNSX and Alpha markets are reporting issuers in Ontario regardless of their jurisdiction of incorporation and the TSX Venture Exchange has adopted MI 61-101 in its entirety.
the offeror nor any joint actor of the offer has, within the preceding 12 months, any board or management representation in respect of the target or any material information concerning the target or its securities that has not been generally disclosed.

Issuer Bids

“Issuer bids” are take-over bids proposed by the issuer. Subject to limited exceptions, where an issuer bid is made, the issuer must provide shareholders with a formal valuation prepared by an independent valuator. In addition, the disclosure document that the issuer provides to shareholders must provide a description of the background to the issuer bid, information concerning every prior valuation, a discussion of the review and approval process adopted by the board of directors and the special committee, a statement of the intention, if known to the issuer after reasonable inquiry, of every interested party to accept or not to accept the issuer bid, and a description of the effect that the issuer anticipates the issuer bid, if successful, will have on the direct or indirect voting interest in the issuer of every interested party. Under MI 61-101, the board of directors of the issuer or an independent committee of the board of directors must determine who the valuator will be and supervise the preparation of the formal valuation.

Business Combinations

“Business combinations” are defined to include arrangements, amalgamations, consolidations or other transactions, as a consequence of which, the interests of a holder of equity securities may be terminated without the holder’s consent. They do not include compulsory acquisitions or downstream transactions, or a transaction where no related party of the issuer (i) directly or directly acquires the issuer or its business or combines with the issuer, (ii) is a party to the transaction or a connected transaction, or (iii) receives a collateral benefit, or consideration that is not identical in form and amount to the consideration to be received by all other holders of securities of the same class, or if the issuer has more than one class of outstanding equity securities, consideration that is greater than the consideration to be received by all other holders of every other class of equity securities in relation to the voting and financial participating interests in the issuer.

The business combination provisions of MI 61-101 apply only to reporting issuers and, unless the transaction satisfies one of the specified exemptions, require a formal valuation as well as “majority of the minority” approval (discussed below). Like issuer bids, the directors of the issuer or an independent committee of the directors must determine who the valuator will be and supervise the preparation of the formal valuation. Exemptions from the formal valuation requirement for business combinations include previous arm’s length negotiations and auctions, as well as exemptions for certain second step business combinations, and business combinations of non-redeemable investment funds or issuers that are not listed on
the TSX, the Aequitas NEO Exchange Inc., the NYSE, the ASX or NASDAQ or on any market outside of Canada and the United States other than AIM or the PLUS market.

**Related Party Transactions**

MI 61-101 also applies to certain types of transactions between an issuer and any person, other than a bona fide lender, that is a related party of the issuer. This includes control persons (of the issuer or of which the issuer is a control person), any person that is a major shareholder or that manages or directs the affairs or operations of the issuer (such as a general partner of a limited partnership), a director or senior officer of the issuer or any of the foregoing, as well as any major subsidiary or affiliated entity of any of the foregoing (see definition of “related party”). A broad range of transactions are covered, including the purchase or sale of assets, lease of property, acquisition of a related party, issuance of or subscription for securities, assumption of the liability, borrowing or lending of money, as well as the release or forgiveness of a debt or liability, amendment to the terms of an outstanding debt or liability or the provision or material amendment of a guarantee or collateral security for debt.

Related party transactions are also subject to specific disclosure requirements and, where not exempt, formal valuation and minority approval. These exemptions include transactions where the fair market value of the subject matter or the value of the consideration is less than 25% of the market capitalization of the issuer, as well as certain transactions in the ordinary course of business or those supported by an arm’s length control person. Where formal valuation is required, it is subject to disclosure and supervision similar to that discussed above.

**Formal Valuation**

Where a formal valuation is required under MI 61-101 it must be prepared by a qualified, independent valuator. While it is a question of fact as to whether the valuator is qualified and independent, MI 61-101 sets out certain relationships that will render a valuator non-independent. These include where the compensation of the valuator is connected to the conclusion that it reaches or the outcome of the transaction, certain circumstances where the valuator is an advisor to an interested party in respect of the transaction or where the valuator has a material financial interest in the completion of the transaction. MI 61-101 also prescribes specific requirements that apply to disclosure relating to the valuator and the subject matter of the valuation, how the valuation is to be prepared, and requirements relating to filing of the formal valuation and obtaining of the valuator’s consent to its disclosure and filing.
Majority of Minority Requirement

Where minority approval is required for a business combination or related party transaction, it must be obtained in a separate class vote from the holders of every class of affected securities and must exclude votes attached to securities that are beneficially owned, controlled or directed by the issuer or any interested party, including any related party of an interested party or any of their joint actors. Despite this prohibition, votes attached to securities acquired under a bid may generally be included in favour of a second step compulsory acquisition provided certain requirements are met.

Independent Committee

As discussed above, under MI 61-101 formal valuations must be supervised by either the board of directors of the issuer or an independent committee of the board (and only an independent committee for insider bids). While it is a question of fact as to whether a director is independent, for these purposes, a director will not be considered independent if he or she, among other things, has a material financial interest in any interested party or an affiliated entity of an interested party to the transaction, or is or has in the previous 12 months been, an employee, associated entity or issuer insider of an interested party or any affiliated entity of an interested party, or an adviser to an interested party or an employee, associated entity, issuer insider or affiliated entity of any such adviser. As well, no member of an independent committee may receive any benefit that is not available on a pro rata basis to other shareholders in Canada or any payment or other benefit that is contingent upon the completion of the transaction (although customary fixed fees for serving as a member of the special committee are permitted). While under MI 61-101 an independent committee of the board is required only for insider bids, it is recommended for all other related party transactions under the rule and Canadian and U.S. judicial decisions and commentary suggest that the use of an independent committee in situations that may involve a conflict of interest is often the only practical manner by which the directors may discharge their duties of loyalty free from the taint of any actual or perceived conflict of interest.

Transactions In Which MI 61-101 Does Not Apply

As mentioned above, where the requirements of MI 61-101 do not apply to a transaction, it is still prudent for directors to look to that rule for guidance on the operation of an independent committee. Guidance can also be found in other statutes and case law. For example, s. 120 of the Canada Business Corporations Act states that where a director or officer has a material interest in a party to a material contract or material transaction with the corporation, disclosure of that interest is required. The CBCA does not define “material contract” or “material transaction”, but, in the context of securities law disclosure requirements, any transaction that
would reasonably be expected to have a significant market price or value of an issuer's securities would be considered material.

Jurisprudence on the role and conduct of an independent committee is rather sparse in Canada. Two prominent decided cases indicate that Ontario courts, at least, are inclined to look at a process involving such a committee in terms of its fairness as a whole, with due regard to the practical realities of the circumstances in question. In *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (C.A.), the Ontario Court of Appeal declined to find oppression under the *Business Corporations Act* (Ontario) where, despite the existence of an independent committee, the CEO and CFO of Schneider were heavily involved in the negotiations with the various bidders. In the court's view, while there was the potential for a conflict of interest, this had to be balanced against the benefit of having senior managers, with their unrivalled knowledge of the company's operations, involved in the discussions. In *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3d) 755 (Gen. Div.), the court declined to find oppression in a case in which the target's CEO had actually sat on the independent committee, although it allowed that this had been a "flaw" that had significantly (though not fatally) "undermined" the process.

Nevertheless, it is essential that any participation by management directors in the negotiation process be limited to the extent that their actions are constrained by MI 61-101 or in situations where there is the potential for a conflict of interest to arise.
Introduction

Overview

While similar in many respects to “traditional” M&A transactions, private equity investments possess distinct characteristics that raise distinct legal and practical issues. For example, private equity investments:

- are often particularly motivated by financial considerations rather than strategic/synergetic considerations;
- are often undertaken with a finite time-frame in mind (although private equity is generally “patient money”);
- are often leveraged with debt and therefore usually require consistent cash flows to service high debt loads;
- they typically include a due diligence period prior to execution to permit evaluation of a business that the private equity purchaser may not be familiar with;
- sometimes involve the acquisition of a minority interest; and
- typically require the retention of competent incumbent management, as private equity players typically do not intend to manage the businesses they acquire with internal expertise.

This Chapter focuses on the issues of relevance to the private equity investor under competition law and foreign investment review; tax structuring; the securities and corporate law aspects of investments in public and private companies, shareholder agreements, and exit strategies; and employment/executive compensation issues.

For the most current developments and commentary in the areas of mergers and acquisitions, securities, competition, and foreign investment review laws please visit and subscribe to Stikeman Elliott’s M&A, securities law and competition/antitrust blogs, accessible via the “Knowledge Hub” on the www.stikeman.com website.

Competition/Antitrust and Foreign Investment Legislation

As discussed in Chapter A of M&A in Canada, competition and foreign investment law are two of the main channels through which federal government policy on acquisitions and foreign ownership is directly expressed. Certain key elements of the legislation can be summarized as follows:

Competition Act

Comprehensive amendments to the Competition Act in 2009 created a U.S. style Hart-Scott-Rodino Act merger notification process, with an initial 30 day “waiting period” and the possibility of a “second request” for additional information. Canadian second
requests had been issued in approximately 10 transactions in each of 2012/13 and 2013/14, which represents a very small percentage of the total number of transactions reviewed by the Competition Bureau in each period. However, a larger number of transactions received second requests in 2015/16 (as many as 20). To date, the “second request” process has not imposed undue burdens on merging parties in Canada, and it has historically been the case that the scope and breadth of Canadian “second requests” was, generally speaking, considerably less than is the case in the U.S. (although, like the number of second requests, their breadth and scope has also been increasing in recent years). Furthermore, the Competition Bureau engages in pre-issuance dialogue, including providing a draft “second request” to the parties, and has published “Merger Review Process Guidelines” intended to further explain the “second request” process. Nevertheless, when a second request does come, complying with it can be a time-consuming and resource-intensive undertaking.

Other points to note about the merger review process include:

- Two financial tests are used to determine whether advance notification of a proposed merger is required: the "transaction size" test (C$87 million in 2016 indexed annually for nominal GDP growth and the "size of parties" test (which includes affiliates of the parties to a transaction) (C$400 million).
- The "advance ruling certificate" (ARC) and "no-action letter" processes, offer an alternative means to satisfy a pre-merger notification obligation.
- The Commissioner of Competition can challenge a non-notifiable transaction that has closed in the absence of an ARC or no-action letter for only one year after closing.

**Investment Canada Act**

In the event of an acquisition of control by a U.S. or other foreign private equity investor of a Canadian business, the acquisition will be subject to federal government review or notification under the *Investment Canada Act*. The review process under the Act is triggered by an “acquisition of control” by a “non-Canadian” of a “Canadian business”. The review threshold for a World Trade Organization (WTO) investor acquiring control of a Canadian business is an “enterprise value” of $1 billion (based on book value of assets) in 2017 (indexed to inflation).

As background, note that the “acquisition of control” by a “non-Canadian” (which would include the Canadian subsidiary of a foreign investor) of a “Canadian business” is either notifiable or reviewable under the Act (absent the availability of an exemption under the ICA). An acquisition of a majority of the voting interests attaching to all shares of a corporation is *deemed* to be an acquisition of control, while an acquisition of at least one-third (but less than a majority) of the voting interests is subject to a *rebuttable presumption* that it is an acquisition of control. An acquisition of control is reviewable where the thresholds discussed above are exceeded.
Other significant aspects of the ICA include:

- The lower review threshold for “sensitive sector” acquisitions (C$5 million in book value of assets) applies only to an acquisition of control of a Canadian business with a cultural component (with no de minimis safe harbour).

- National security reviews may be conducted with respect to any foreign investments in Canadian businesses. Such reviews are intended to ensure that investments are not “injurious to national security” (an undefined term). Because there is no review threshold, small transactions may be subject to review. Most significantly, from the point of view of private equity investors (especially Sovereign Wealth Funds), even minority investments that do not result in control of a Canadian business may be caught. Industry Canada has suggested that they do not anticipate a significant number of national security cases, in part because they expect to involve the Canadian Department of Public Safety and possibly even the federal Cabinet in the decision-making process. To date, only a very small number of proposed transactions have triggered the national security review process. Practically speaking, therefore, this process has not proved to be a material impediment to foreign investment in Canada. However, the ICA was amended in 2015, which increased the length of certain time periods to carry out national security reviews and gave the federal government the flexibility to extend reviews.

The ICA has attracted considerable political and media attention, principally as the result of application to some high profile transactions:

- The 2008 rejection of U.S.-based Alliant Techsystems Inc.’s (“ATK”) proposed acquisition of the information systems business of MacDonald, Dettwiler and Associates Ltd (“MDA”); 

- The lawsuit brought by the Attorney General of Canada (the “AGC”) against US Steel Corporation for alleged breach of its undertakings given in respect of its acquisition of control of Stelco Inc., in which the AGC sought specific performance of the undertakings and additional financial penalties (which lawsuit was ultimately settled); 

- The 2010 rejection of Australia-based BHP Billiton’s hostile takeover bid for Potash Corporation of Saskatchewan; and 

- The 2012 approvals of Chinese state-owned enterprise (“SOE”) CNOOC’s takeover of Nexen and Malaysian SOE PETRONAS's takeover of Progress Energy.

While these events have led some to question the message that Canada is sending to international investors, careful examination of the facts of each case suggests that they are not indicative of any wider trend towards protectionism. For example, the ATK-MDA transaction involved the Radarsat satellites, which are of considerable sensitivity to the Canadian government. In the case of US Steel Corporation, it seems likely that the Government of Canada felt compelled to act given the extreme level of alleged non-compliance with the undertakings – Canadian facilities ceased operating entirely while U.S. Steel Corporation continued operations at some of its U.S. facilities. In the case of Potash Corporation of Saskatchewan, numerous unique
features were present, including the disproportionate significance of the company's business to a single, relatively small province.

The CNOOC-Nexen and PETRONAS-Progress transactions in the oil sands industry relate to concerns unique to investments by foreign SOEs. These concerns may have prompted amendments to the ICA specifically aimed at investments by foreign SOEs. The term “SOE” is defined broadly to include governments of foreign states, entities directly or indirectly controlled or influenced by those states, as well as individuals acting under the direction or direct or indirect influence of a foreign government or agency. The federal government was given the discretion to determine that a minority acquisition by a SOE investor may constitute an acquisition of control. Investments by SOE investors face a significantly lower threshold of $379 million in 2017 (based on book value of assets, indexed to nominal GDP growth), over which the investments are reviewable under the Act. Moreover, foreign SOE investments are likely to face heightened scrutiny under the national security review provisions of the ICA. Notification forms seek information intended to assess the extent of SOE control, direction or influence. These requirements introduce additional considerations for private equity funds with material investments by foreign government entities, especially Sovereign Wealth Funds.

Other statutes relevant for foreign investments

There are many other federal statutes (e.g., the Telecommunications Act, Insurance Companies Act and Aeronautics Act) and provincial statutes (e.g., in Ontario, the Paperback and Periodical Distributors Act, Insurance Act and Mortgage Brokers Act) that include restrictions on foreign ownership (or foreign directors) or prohibitions or restrictions on the carrying on of certain kinds of business by “non-Canadians”.

Subjects Considered in the Remainder of this Chapter

The remaining sections of Private Equity Investment in Canada give in-depth consideration to the following key issues:

- Tax considerations for inbound private equity investments;
- Private equity investment in public companies (PIPEs);
- Private equity investments in private companies, including
  a) Shareholder agreements;
  b) Exit strategies; and
- Executive employment and compensation issues.

Tax Considerations For Inbound Private Equity Investments

Many tax and commercial factors influence the structure and financing of a private equity investment in Canada, and the options will vary depending upon the investor's status, residence and overall tax situation, including applicable tax rates. The discussion in this section highlights some of the key considerations relevant to
U.S. and other foreign private equity investors acquiring or investing in a Canadian business. The tax considerations relevant to the determination of whether to acquire the assets or shares of a privately-held corporation are discussed in Chapter B, "Acquiring a Private Company or its Assets" of *M&A in Canada*.

**Structuring Considerations**

**Using a Canadian Acquisition Company**

A non-resident making a private equity investment in Canada will typically establish a Canadian acquisition subsidiary.

Among other advantages, using a Canadian acquisition subsidiary facilitates:

- **Deduction of financing expenses** against the target’s income,
- **Return of the capital invested** free of Canadian withholding tax, and
- **Step-up** of the tax cost of certain of the target’s capital assets.

**Deduction of Financing Expenses**

Relative tax rates will influence the determination of where financing expenses are most efficiently incurred. To permit financing expenses to be deductible against the Canadian target’s income, a Canadian acquisition corporation may act as borrower and on, or immediately after, the acquisition amalgamate (similar to a “merger” under U.S. law) with the target. The amalgamation is necessary to bring the interest expense and operating revenues into one entity, because Canadian tax law does not provide for consolidated returns within a corporate group.

**Return of the Capital Invested**

Generally speaking a non-public (for tax purposes), Canadian corporation can return paid-up capital (“PUC”) to a non-resident shareholder free of Canadian withholding tax. Unlike in the United States, there is no requirement to pay out earnings before returning capital. The PUC of the Canadian acquisition company will be equal to the full amount contributed for its shares, an amount that is typically greater than the target’s historical PUC. Canada’s cross-border anti-surplus stripping rules will limit the ability of taxpayers to engage in post-acquisition planning where a target with low PUC is acquired, so it is important to fully capitalize a Canadian acquisition corporation from the outset.

**Step-up or “Bump”**

Where a non-resident acquires the shares of a Canadian corporation it may be possible to take certain assets out of the target post-closing on a tax-free basis by "bumping" the cost of capital properties owned by the target on the acquisition. This "bump" in cost base is available only with respect to non-depreciable capital assets, such as land and shares (it cannot be used to take goodwill or most other operating
assets out of a corporation). Often when a non-resident acquires a Canadian target with a foreign subsidiary the non-resident will benefit from bumping the shares of the foreign subsidiary and distributing them out of the target so that they are no longer held by the Canadian corporation. Determining the availability of the "bump" is a fact-dependent exercise and there are a number of limitations on when the bump can be used.

**Foreign Affiliate Dumping Rules**

If the Canadian target derives significant value from shares of foreign subsidiaries, a Canadian acquisition corporation that is controlled by a non-resident will be subject to the “foreign affiliate dumping rules.” These rules are intended to prevent “debt dumping” into a Canadian subsidiary or the making of surplus-stripping investments in group foreign affiliates. When applicable, the rules trigger a deemed dividend subject to withholding tax or an automatic reduction to the available PUC of shares held by the foreign parent in the Canadian corporation.

These rules must also be considered post-acquisition, in any case where a Canadian corporation that is controlled by the non-resident makes “investments” (as defined broadly in the *Income Tax Act* (Canada)) in foreign subsidiaries.

**Financing Considerations**

**Withholding Tax on Interest**

There is generally no withholding tax on interest paid to non-resident lenders that deal at *arm’s length* with a Canadian resident payer, unless the interest is “participating debt interest.” Interest paid to non-residents who do *not deal at arm’s length* with the payer is subject to withholding tax of 25% unless reduced under an applicable tax treaty. The Canada-U.S. tax treaty eliminates withholding tax on all interest (except participating debt interest), including interest between non-arm’s length parties, for recipients entitled to the benefits of the treaty.

**Withholding Tax on Dividends**

Dividends paid by Canadian corporations to non-resident shareholders will be subject to Canadian withholding tax at a rate of 25%, unless reduced under an applicable tax treaty. The Canada-U.S. tax treaty reduces the rate to 5% for corporations that own at least 10% of the voting shares of the company paying the dividend, and 15% in other cases.

**Proportion of Debt to equity**

Canada’s thin-capitalization rules effectively limit the proportion of debt to equity that significant non-resident shareholders (and certain related persons) can invest in Canadian corporations. In general, arm’s length debt does not affect the thin capitalization limits; relevant equity includes PUC, surplus contributed by the non-
resident shareholder, and retained earnings (so the payment of a dividend or return of capital will reduce relevant equity for thin capitalization purposes). The permitted debt to equity ratio is 1.5:1. If the 1.5:1 ratio is exceeded, the Canadian corporation will not be able to deduct interest in respect of the excessive debt, and interest payments will be treated as dividends subject to non-resident withholding tax. Similar rules exist for trusts, partnerships and non-resident corporations.

Anti-avoidance Rule for “Back-to-back” Loans and Credit Support.

Complex anti-avoidance rules apply to certain “back-to-back” loan and credit support arrangements. These rules are intended to prevent the use of an accommodation party to circumvent the thin capitalization rules or the imposition of withholding tax on interest paid to non-arm’s length parties. The rules are complex and should be considered in the context of any cross-border funding, particularly where multinational group borrowing arrangements are involved.

Transfer Pricing

Payments, including interest payments, made by Canadian residents to non-arm’s length non-residents must comply with Canada’s transfer pricing rules. Among other things, this means that interest paid by a Canadian corporation to a non-arm’s length person must reflect an arm’s length rate of interest.

Hybrid Debt Structure

Hybrid instruments are instruments that are treated as debt or equity in one country and the opposite in another country. This mismatch in tax treatment can provide opportunities to increase a corporate group’s global tax efficiency. Hybrid debt and other types of hybrid instruments may be used to efficiently fund cross-border investments into Canada in certain situations.

Other Considerations

Tax treaties

Canada has a wide network of tax treaties which reduce the circumstances in which non-residents may be subject to Canadian income tax, and rates of withholding tax on payments of interest, dividends and royalties. Typically tax treaties apply to anyone who is a resident for tax purposes of the relevant country. Unique to the Canada-U.S. tax treaty is a “limitation on benefits” rule which restricts the ability of certain people to rely on the treaty. The application of this rule is complex and needs to be considered on a case-by-case basis. For private equity investors who are not US residents entitled to benefits of the U.S. tax treaty consideration should be given to the possible application of other tax treaties in structuring their investment into Canada.
Exchangeable Share Structures

Exchangeable share structures (also known as dividend access share structures) are often used in cross-border acquisitions where a purchaser proposes to acquire a Canadian target for consideration that includes issuing its own shares. The exchangeable share structure is used because Canadian tax law provides for a rollover (deferral of gain) only if a seller receives shares of a Canadian corporation. To preserve a rollover for the Canadian shareholders of the target, a foreign buyer may form a Canadian subsidiary that will issue shares that are exchangeable into the buyer’s shares. These exchangeable shares are intended to be the economic equivalent of the buyer’s shares (for example they typically have a dividend entitlement that mirrors the dividends paid on the buyer’s shares). The Canadian seller accepts the exchangeable shares in payment (or partial payment) on disposition of the target’s shares. Because the Canadian seller receives shares that are issued by a Canadian corporation, the Canadian seller generally will not pay Canadian tax until those exchangeable shares are exchanged for the non-resident buyer’s shares. There are a number of corporate and tax considerations to be addressed with respect to an exchangeable share structure, but in many cases such a structure can be implemented to the satisfaction of all sides.

Exit Considerations

Non-resident investors are generally not subject to Canadian tax on capital gains realized on a disposition of shares of a Canadian corporation; tax is imposed only if at any time in the 60 months preceding the sale the shares derived more than 50% of their fair market value from real property situated in Canada, Canadian resource properties, timber resource properties, or options in respect of them (and, in the case of publicly listed shares, if the non-resident, non-arm’s length persons and partnerships in which they hold membership held more than 25% of the shares of any class of the corporation). Under certain of Canada’s income tax treaties, including the Canada-U.S. tax treaty, the application of the tax is narrowed by applying it only to gains on sales of shares that derive their value from real property situate in Canada at the time the shares are sold.

Private Equity Investments in Public Companies (PIPSES)

The issues raised by a private equity investment depend on the type of transaction that is contemplated. For example, there will be more legal issues to consider where a private equity investment would produce a change of control or where the investment is in a large public corporation (typically a “reporting issuer”), as compared to a small private company with a handful of shareholders. In this section, we consider investments in public companies – both those that do not involve a change of control (often referred to as “private investments in public equity”, or PIPEs) and those that do.
Private Placements: No Change of Control

Securities Law Exemptions

In order to avoid the onerous registration and prospectus requirements of applicable securities legislation, private equity investors investing in Canadian public companies have traditionally relied upon various exemptions under that legislation – including the “accredited investor” and “minimum amount investment” exemptions. National Instrument 45-106 (“NI 45-106”) consolidates and harmonizes many of the more common prospectus exemptions available under Canada’s various provincial and territorial securities law regimes – although some jurisdictional differences remain.

With respect to equity financings, several possible capital raising exemptions may be available. Generally, private equity investors will want to ensure their proposed transaction falls under one of the following NI 45-106 exemptions:

**Accredited Investors**

Securities of any value can be issued and traded on an exempt basis to “accredited investors”, who include, among others, Canadian financial institutions and entities with net assets over a specified amount (currently C$5,000,000) purchasing as principals. Most categories of accredited investor that apply to individuals require that they sign a risk acknowledgement form before agreeing to purchase securities under this exemption. When relying on this exemption, the issuer must file a report of exempt distribution and pay a fee. The first trade in securities purchased under this exemption is subject to a 4-month hold period unless another exemption is available or the securities are qualified by a prospectus.

**Minimum Amount Investment**

Securities can be issued and traded on an exempt basis to any purchaser (other than an individual) purchasing as principal if the securities have an acquisition cost of at least C$150,000, paid in cash on closing. The securities issued and traded must be of a single issuer, but more than one kind of security (such as shares and debt) can be sold in units that in total meet the minimum acquisition cost. If an issuer wants to rely on this exemption for additional investments they must also have an acquisition cost of at least C$150,000. In addition, this exemption requires the issuer to file a report of exempt distribution and to pay a fee. The first trade in securities purchased under this exemption is subject to a 4-month hold period unless another exemption is available or the securities are qualified by a prospectus.

**Offering Memorandum**

A trade by an issuer of securities 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 the issuer obtains a risk acknowledgement statement from the purchaser. It should be noted the exemption does not operate uniformly across all jurisdictions and that the preparation of an offering memorandum, and in some jurisdictions, the ongoing disclosure obligations imposed on non-reporting issuers, can be onerous.
Private Issuer Exemption
As its name implies, a fourth major exemption – the “private issuer” exemption – applies primarily in the case of investment in privately held companies. This exemption is discussed in the section “Private Equity Investments in Private companies”, below.

Other Exemptions
While the exemptions described above are the ones most commonly used by private equity investors, a number of other exemptions may be available, including the “friends, family, and business associates” exemption, the “rights offering” exemption, the “existing security holder” exemption, and a new “crowdfunding” exemption available only in certain provinces (including Ontario). While these exemptions each operate differently, with some limiting who can buy securities and/or how much investors may invest under the exemption, other than the “rights offering” exemption, they all require a report of exempt distribution to be filed by the issuer and place restrictions on the first trade of securities.

Continuous Disclosure Requirements
As is the case in other jurisdictions, a Canadian public company (or a “reporting issuer”) is required to file a range of documents with securities authorities. Among these are:
- Interim and annual financial statements;
- Management’s Discussion and Analysis (MD&A);
- Annual Information Form (AIF);
- Material change reports; and
- Management information circulars.

This is significant for investors in public companies because, in some cases, the public company’s continuous disclosure filings may require the provision of certain information about the investor and its involvement with the public company (including future plans). Such requirements are usually similar, generally speaking, to those that exist in the U.S. and other jurisdictions.

Change of Control Transactions
Mechanisms
In the event that the transaction in question involves a change in control of the target, the requirements of applicable corporate and securities laws are much more complex. Three basic mechanisms are commonly used in Canadian public M&A transactions:
- Take-over bid;
- Plan of arrangement; and
- Statutory amalgamation (“squeeze-out”).
These are summarized in sequence below, followed by a discussion of directors’ duties. For a more detailed discussion, see Chapter C of M&A in Canada, “Acquiring a Public Company”.

**Take-over Bid**

A take-over bid is similar to a U.S. “tender offer”, except that (i) the Canadian take-over mechanism is sometimes used to effect “friendly” transactions and (ii) Canadian take-over bids are defined by a “bright line” test according to which an offer to acquire voting or equity securities of an issuer that would bring the bidder’s holdings (together with those of its joint actors) to 20% or more of the outstanding securities is deemed to be a take-over bid.

**Timeline of a Bid**

A take-over bid may be commenced by either (i) publishing an advertisement in a newspaper, in which case the date of the take-over bid is the date of publication, or (ii) mailing the take-over bid circular to the shareholders of the target, in which case the date of the take-over bid is the date of mailing. Where a take-over bid is commenced by means of an advertisement, the bidder must have requested a shareholders list from the target contemporaneously with or prior to the publication. Within 2 business days of receiving the list, the bidder must send a take-over bid circular (which contains details of the offer and certain mandated disclosures) to the shareholders on the list. Regardless of how the bid is commenced, within 15 days of the bid, the directors of the target must prepare and send a directors’ circular recommending acceptance or rejection of the bid. The take-over bid must remain open for at least 35 days.

The mandatory minimum deposit period is 105 days (which may be reduced to no less than 35 days in some circumstances) and requires that more than 50% of the outstanding securities owned by persons other than the bidder (and any joint actors) be tendered before the bidder can take-up any securities tendered under the bid. In addition, the bid period must be extended by 10 days after the minimum tender condition is satisfied and all other conditions of the bid have been satisfied or waived.

**No Collateral Agreements / No Financing Conditions**

As shareholders must be offered identical consideration (or identical choice of consideration), collateral agreements are generally not permitted, with certain exceptions. One major distinction between U.S. and Canadian practice is that in Canada adequate financing arrangements must be in place at the time of the bid. Therefore it is not the practice in Canada for bids to be conditional on financing.

**Squeeze-outs and Compulsory Acquisitions**

Where enough shares are tendered to bring the bidder’s interest to 90% or more, a statutory compulsory acquisition procedure is available under Canadian corporate
law under which the remaining shares can be acquired, subject to dissent and appraisal rights. Where enough shares are tendered to the bid to bring the bidder’s interest in the company to the 66 2/3% level (75% if the target is incorporated in certain jurisdictions), but not to the 90% level, a second-step squeeze-out is usually possible, conditional on “majority of minority” support and subject to dissent and appraisal rights. Bids often include a minimum deposit (tender) condition to ensure the bidder can obtain the remaining shares not deposited through a second-step “going private” (squeeze-out) transaction, as described below. This condition typically requires deposit by at least (i) 66 2/3% of outstanding shares (75% in certain jurisdictions) in order to effect an amalgamation or other “squeeze-out” corporate action, and (ii) a “majority of the minority”.

Plan of Arrangement

A plan of arrangement is a court-sanctioned procedure that allows a solvent company to effect fundamental changes, including a combination with one or more other companies. An arrangement is often the preferred method in a negotiated acquisition because of the court’s broad discretion to approve complex or deal-specific terms, and because it allows for more “conditional” forms of financing. Shareholders must approve any arrangement, but the terms under which the shareholders’ meeting will proceed are set out by the court, as is the threshold for approval (usually set at 66 2/3%, with a “majority of minority” requirement if a related party transaction). Courts will often divide securityholders who are affected differently (e.g. common vs. preferred shareholders) into distinct classes for approval purposes. Although not required by statute, dissent and appraisal rights are usually part of the court-mandated process. Final approval of the court is necessary, which is usually granted following the requisite shareholder approval and where the arrangement is found by the court to be “fair and reasonable”.

Statutory Amalgamation

Essentially the Canadian statutory equivalent of what is known in the U.S. as a “merger”, an amalgamation is a process by which two or more business corporations are combined into a single continuing corporation. The difference in Canada is that neither corporation ceases to exist, rather they continue as a combined entity. An amalgamated corporation takes on all the property, assets, rights and liabilities of each of the amalgamating corporations – a seamless transition that is often commercially advantageous because assets and liabilities are not deemed to have been transferred or assumed (avoiding most (but not all) consent requirements and transfer taxes). Amalgamations, which are negotiated transactions, require 66 2/3% shareholder approval (75% in certain jurisdictions) and in the case of a “related party transaction” (e.g. a going private transaction) may require “majority of minority” approval. Amalgamations are subject to a statutory dissent and appraisal right.
**Directors’ Duties**

In a change of control situation, the board of directors of a Canadian business corporation will be subject to a number of specific duties, as set out in detail in Chapter D of *M&A in Canada*, “Duties of the Target Board”.

In Canada, directors generally have three fundamental statutory duties:

- The duty to manage or supervise the management of the corporation,
- A fiduciary duty to act honestly and in good faith with a view to the best interests of the corporation, including a duty to avoid conflicts of interest, and
- A duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Canadian case law, notably *BCE v. 1976 Debentureholders*, has clarified these duties (specifically, in the context of CBCA corporations, although the principles would apply more broadly) as follows:

- The fiduciary duty of directors is owed to the corporation. That is, it is a duty to “create a better corporation”, as the Supreme Court held in *Peoples Department Stores*. However, the Supreme Court has also stated that, in discharging this duty to the corporation, it may be appropriate for the directors to consider the potential effect of corporate decisions on the reasonable expectations of shareholders or other stakeholders, including employees, suppliers, creditors, consumers, governments and the environment. There is no rigid “priority rule” requiring that the shareholders prevail in all cases.
- Directors owe a duty of care, distinct from the fiduciary duty, to the corporation and (under the CBCA and some of the provincial Acts) to its shareholders, securityholders and creditors.
- The “business judgment rule” will generally protect business decisions which have been made by a board honestly, prudently, in good faith and on reasonable grounds. A court will generally defer to a board’s business judgment provided that its chosen course of action fell within a range of reasonable alternatives.

In change of control scenarios, Canadian securities regulators have arguably come to play a more pivotal role than the country’s courts. While the governing principles are admittedly less than perfectly clear, recent rulings have stressed the board’s duty to permit bids to proceed to shareholder votes. The effectiveness of poison pills is accordingly strictly time-limited and “Just Say No” appears not to be a viable option in the great majority of potential change of control scenarios. There is some tension between these regulatory rulings and Canadian jurisprudence, such as the *BCE* ruling, that tends to emphasize the board’s fiduciary duties to the corporation as a whole, which in theory would seem to allow more room for boards to apply judgment in responding to take-over bids. But for now, the view coming out of the securities commissions is for practical purposes the dominant one in Canada.

Below we discuss some further considerations for directors in discharging their duties in a change of control situation.
**Oppression**

Under most Canadian business corporations statutes, corporations and their directors (among others) can be liable for actions that are “oppressive or unfairly prejudicial” to the interests of any of a wide range of stakeholders, including shareholders and creditors. In general, Canadian courts exercise their discretion to apply this “oppression remedy” with a focus on the “reasonable expectations” of the party alleging oppression and with respect to the business judgment rule. Because of its breadth and highly flexible equitable nature, the oppression remedy is frequently the first resort of disgruntled shareholders and creditors in Canada in a change of control transaction.

**The BCE Ruling: Stakeholders’ Reasonable Expectations and Board’s Business Judgement**

In *BCE*, the Supreme Court of Canada rejected an oppression claim by some of BCE’s debentureholders. The claimants had argued that the trading value and investment-grade status of their holdings was threatened by the proposed plan of arrangement. The Supreme Court held that while a proposed arrangement must serve a valid business purpose, it need not be “perfect”, provided that it adequately responds to the reasonable expectations of the affected stakeholders. Citing *Re Canadian Pacific Ltd.* (1990), 73 O.R. (2d) 212 (H.C.), the Court noted that where a transaction is necessary to the continued survival of the target, an arrangement is more likely to be approved in spite of a prejudicial effect on certain classes of stakeholder – a point that may be of significance to private equity firms targeting weak or distressed businesses for their “turn-around” potential.

In rejecting the debentureholders’ claim, the Supreme Court concluded that the BCE board’s decision to proceed fell within a “range of reasonable choices that they could have made in weighing conflicting interests” and that there could not have been a reasonable expectation that the company would act so as to ensure that the debentures remained at “investment grade” levels, particularly given that such an obligation could have been negotiated into the contract between the parties but was not.

This ruling, which is one of the most significant Supreme Court judgments on directors’ duties in plans of arrangement to date, strongly suggests that the Canadian courts will continue to be pragmatic and generally deferential to the business judgment of the board where it is exercised in an informed, prudent and reasonable manner.

**Defensive Tactics and Deal Protection Generally**

Whether it is implemented by way of a plan of arrangement, take-over bid, amalgamation or otherwise, the role of the target’s board of directors is critical in a change of control transaction involving a Canadian publicly-listed target. In
particular, the board’s capacity to use defensive tactics and deal protection mechanisms should be exercised with a number of points in mind:

- The latitude to implement such tactics and mechanisms is subject to the fiduciary duties of directors (and the related duty of care and the duty to manage the corporation), which, as noted above, are imposed by statute in a form that is in some respects stronger than the corresponding equitable or common law duties.

- In light of these duties, and because Canadian securities regulators have clearly stated that securities legislation has, as its primary objective, the protection of the bona fide interests of the shareholders of the target company, the directors of a Canadian target company are limited both in the defensive tactics they can employ to fend off an unwanted suitor and the deal protection devices they can provide to a potential acquiror.

- In Canada, structural techniques (such as shareholder rights plans and charter and bylaw restrictions) either are not used or are relatively benign - the chief exception being negotiated standstill agreements.

- When they are used, shareholder rights plans are generally only permitted to exist for a limited period to allow the board time to consider an appropriate response to a take-over bid, although this is an evolving issue that will certainly be impacted by the given take-over bid rules discussed above.

- Tactical defences ("just say no", capital restructuring, "Crown jewel" options etc.) are not widely used because, under Canadian law, they must have a demonstrable business purpose and may open the action to claims by shareholders or regulators. A negotiated support (or "merger") agreement with a white knight is a much more common response in Canada.

- Because a “just say no” defence is very difficult to rely upon in Canada, it is generally quite likely that, once a Canadian target is in play, a transaction will result (not infrequently involving a “white knight”).

- Deal protection devices employed in Canada are generally in line with U.S. practice and include break fees, non-solicitation covenants, matching rights (typically when a “superior proposal” is received by the target and the directors exercise their “fiduciary out”) and lock-up agreements with key shareholders.

- As in the U.S., the “process” adopted by the board is extremely important in establishing whether its members have satisfied their fiduciary and other statutory duties. Key process issues can include the formation of a special committee (including timing and member independence issues), the timeliness of responses to bidders, the appropriate use of advisors, and the control and use of company assets (e.g. confidential information).

- As discussed above, the Canadian courts have endorsed the U.S. “business judgment” doctrine, under which, in many types of situation, they will defer to the decision of an informed board made honestly, prudently, in good faith and on reasonable grounds.
• The Canadian courts have essentially rejected the U.S. Revlon duty (understood as the duty of a board to maximize shareholder value in a change of control transaction). In spite of that, the Canadian approach could plausibly be described as a modified Revlon test under which the board of a Canadian target has a duty to achieve the best value reasonably available to shareholders, with due regard to the reasonable expectations of other stakeholders in the corporation and to the interests of the corporation as a whole.

• For a variety of reasons (discussed in detail in Chapter C of M&A in Canada), many change of control transactions in Canada proceed by way of a statutory plan of arrangement, which requires a fairness hearing as an integral part of obtaining court approval.

• As also discussed above, Canadian company law creates a broad oppression remedy that is available to a securityholder, creditor or other complainant seeking redress for "oppressive or unfairly prejudicial" acts or acts that unfairly disregard their interests. In its BCE ruling, discussed above, the Supreme Court of Canada specifically named poison pills as exemplifying "unfair prejudice" under the oppression remedy. The fairness hearing required to approve a plan of arrangement often provides an ideal setting for an oppression claim.

Private Equity Investments in Private Companies

Making the Investment: Prospectus Exemptions

As discussed above in relation to public companies, NI 45-106 harmonizes prospectus requirements under Canada's various provincial and territorial securities law regimes. While the exemptions reviewed above ("accredited investor", "minimum amount investment" and "offering memorandum") are not specifically restricted to public companies, the "private issuer" exemption is the most comprehensive and useful in the context of a private company.

Private Issuer Exemption

Securities, of any value, of "private issuers" can be distributed on an exempt basis to certain specified investors purchasing as principals (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 an issuer that is not a "reporting issuer" or an investment fund and whose constating documents or shareholder agreements contain restrictions on the transfer of its securities (other than non-convertible debt securities). To be considered a "private issuer", the issuer's securities must also not be beneficially owned by more than 50 persons (not including employees or former employees). The "private issuer" exemption will only apply where the issuer has distributed its securities to certain specified investors. Importantly, if a private issuer distributes securities to a person that is not specified in the exemption (and even where the distribution relies on another exemption) it will no longer be a private issuer and will not be able to continue to
use the “private issuer” exemption. The general premise is to restrict an issuer from
distributing securities to “to the public”, which is a fact-specific determination and a
concept that has been interpreted very broadly in the context of securities trading.
No report of exempt distribution need be made (nor is any fee required) with
respect to the issuance or trade of exempt securities of private issuers.

**Structuring the Relationship: Shareholder Agreements**

Private equity investors, who often take minority interests in private companies,
will generally want to ensure that shareholder agreements are in place that will
allow them sufficient influence and flexibility to pursue their goals (typically, to
increase the value of the business and, once this has been achieved, to make an easy
and profitable exit at an appropriate time). In most cases the type of shareholder
agreement that is required to achieve this is the “Unanimous Shareholder
Agreement” (“USA”), a type of shareholder agreement that has a special status under
Canadian business corporations statutes. The USA and its typical provisions are
discussed in the following subsections.

**The Special Status of a USA**

In Canadian law, a “shareholder agreement” refers to an omnibus agreement that
will generally contain the kind of provisions that, in U.S. practice, would be the
subject of separate shareholder agreements, “investor rights” agreements and
“registration rights” agreements. Under Canadian law, an ordinary shareholder
agreement is just another type of commercial contract, which means that it is
subordinate to the articles and by-laws of the corporation (and to the provisions of
the business corporations statute that governs the corporation in question). A
Unanimous Shareholder Agreement is different: a USA has a special “hybrid” status,
being partly contractual but also partly constitutional (e.g., for certain purposes,
notably determinations of *de jure* control, the USA is considered one of the
“constating documents” of the corporation. See *Duha Printers (Western) Ltd. v. The
(CanLII) for analysis of the nature of a USA).

What this means, practically speaking, is that shareholders who enter into a USA can
avoid certain statutory requirements, something that cannot ordinarily be achieved
through contract. Most significantly, a USA can limit the powers that a corporation’s
directors normally exercise, directly or through their oversight of management, over
a corporation. The USA, which is contemplated by most Canadian business
corporations statutes, provides a unique opportunity for shareholders to shape a
corporation’s constitutional and governance structure to suit their particular
purposes – including the purposes of a private equity shareholder.
What a USA Typically Contains

Parties to a USA must include all registered shareholders of all classes (whether voting, non-voting, common or preferred). In a USA, shareholders will typically agree to vary or contract out of certain statutory requirements. For example, they may

- Require votes of directors or shareholders on specified matters where such votes are not required by the statute (e.g., on contracts involving a certain dollar amount);
- Require higher majorities than are specified in the governing statute (e.g., 90% instead of 66 2/3% for amendments to articles), or provide certain shareholders with veto rights; or
- Limit or “fetter” the directors’ discretion with respect to 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.

Advantages of a USA

Among the many advantages of a USA, two stand out as particularly important:

- USAs are binding upon purchasers of shares of the corporation without signing (legending of share certificates is required under some statutes - others give a right of rescission to purchasers without notice of the USA); and
- There are methods of enforcement under the relevant corporate statutes that go beyond ordinary contractual remedies, including having the regulator under the relevant corporate statute enforce a compliance order.

In addition, a USA (even one that exists only for a limited time or limited purpose) can allow for the approval of corporate actions which the incumbent board may be reluctant to approve (e.g. for reasons of potential liability).

Shareholder Liability Under a USA

To the extent that a USA restricts the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation, the parties to the USA who assume those powers (usually the shareholders) assume not only all the rights and powers of a director of the corporation, but their duties and liabilities as well, whether arising under the corporate statute or otherwise. Such liabilities could include, for example:

- Liabilities under the corporate statute, such as liabilities 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) or provincial harmonized or retail sales tax regimes; and
Liability for amounts owing under other non-corporate statutes, such as the Employment Standards Act, Environmental Protection Act, and Pension Benefits Act of Ontario, or their equivalents in other jurisdictions.

As is the case in the U.S. and other countries, it is not just business corporations statutes that confer rights, duties and liabilities on corporate directors. Whether a USA can relieve directors of statutory obligations and liabilities under other types of legislation depends on the wording of each individual statute. For instance, Section 2(2) of Ontario’s Occupational Health and Safety Act 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.

Corporate Governance Issues and the USA

Private equity investors will usually require the appointment of nominees to the board of directors. If nominee directors are to be appointed, it is important that the USA provide for the reduction or termination of a shareholder’s right to nominate directors under specified circumstances, which could include:

- A decrease in the shareholder’s proportionate ownership from its initial percentage, including as the result of the 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 USA should also provide that any corporate law requirements relating to the number of Canadian resident directors are complied with by the nominating shareholders.

Nominee Directors’ Conflicting Loyalties

As is generally the case in the U.S., directors of Canadian corporations who are nominees of a particular shareholder have the same fiduciary duty as the rest of the board: to act in the best interests of the corporation. Because this is so even where those “best interests” are inconsistent with those of the nominating shareholder (with a limited exception under Alberta’s Business Corporations Act), a nominee director may be placed, at times, in an awkward position. This problem can be overcome under a USA 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 (more of a “negative control” or veto approach).
Shareholder Veto Rights

Another way to avoid issues at the board level, commonly reflected in a USA, is to provide that all extraordinary matters require shareholder approval. From the private equity perspective, such an approach works well because private equity investors tend to be less concerned about day-to-day decision-making than they are with strategic decisions that could directly affect their economic interests. Thus private equity investors will typically want 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-arm’s length transactions and other non-ordinary course events.

Observer Status

For private equity investors, an alternative to board representation may be observer status. Observer status is a contractual right which typically 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 Canada Business Corporations Act (“CBCA”) and some of its provincial counterparts, “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 convert 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 type normally obtained by directors, if it is available.

Meetings

The USA 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 a USA

In order to qualify the corporation as a “private issuer” for securities law purposes and for other business reasons, a USA will include a restriction on transfer of securities (save and except as otherwise specifically provided in the agreement to
certain permitted transferees). In order to provide the private equity investor with liquidity, the following procedures are common, either alone or in combination:

**Right of First Refusal (ROFR)**

A ROFR provides that after receiving a *bona fide* arm’s-length binding offer and prior to selling its shares to a third party pursuant to such 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 be viewed as having a negative impact on 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 possible to circumscribe the terms and conditions that the 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 parties may also want to make it clear in the USA that selling notices cannot allow for superior proposals and are void to the extent that they do (absent such express language a superior proposal condition in a selling notice can be effective: *Katotakis v. William R. Waters Ltd.* (2005), 1 B.L.R. (4th) 168 (Ont. C.A.).

**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 typically requires a shareholder wishing to exit to offer its shares to the other shareholders on specified terms and conditions first (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 during a stipulated period. Once again, the USA 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 may be exercised by a minority shareholder
in conjunction with a ROFO or ROFR, thereby avoiding having the minority shareholder left in a minority position with a new majority shareholder.

Drag-along Rights

Drag-along rights are the reverse of tag-along rights. They permit a specified majority of shareholders who have an agreement with a third party to sell their shares on specified terms and conditions to require holders of the remaining shares to also sell all of their shares to the third party, effecting a sale of 100% of the shares. Drag-alongs are a popular method for preventing a dissenting minority from blocking transactions that the majority desires. In some U.S. states, drag-alongs have been found unenforceable insofar as they purport to be effective waivers of statutory dissent rights. Where a provision is well drafted, this problem is not generally faced under the corresponding Canadian statutes, whose USA provisions give shareholders wide latitude to structure their relationships independently of the rules that the statutes apply in other situations.

A private equity investor who agrees to include a drag-along in the USA should ensure that its liabilities for breaches of representations, warranties and indemnities are stated to be pro rata rather than “joint and several” and (preferably) capped at the amount of the purchase price paid to it or a percentage thereof. Moreover, the USA should state that any agreement into which the private equity investor is to be “dragged” must not be drafted in a way that could affect the investor’s right to own, use or exploit its assets or prevent or restrict its ability to make investments in any business, or contain any non-competition covenants, non-disclosure provisions or other restrictive covenants that would bind it in any way without its consent.

Considerations Applying to All of the Foregoing

USAs 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 transfer of shares, 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 details in a shareholder agreement.

It is also critical to be clear about 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, it should be stated that any transferee will become a party to the existing USA.
Shareholder Agreements: Tips for Private Equity Investors

In negotiating and settling shareholder agreements, private equity investors should consider the following in light of their equity ownership, special circumstances and requirements:

- **Director issues**: ensure frequent board meetings; consider observer status; consider D&O insurance; consider indemnities not only from the corporation but also key shareholders; ensure that separate indemnity agreements are obtained (and deal with the interaction with your fund’s indemnity and D&O insurance); and (in the case of U.S. private equity investors) consider how to comply with any “resident Canadian” director requirements (for corporations formed in certain Canadian jurisdictions).

- **ROFOs vs. ROFRs**: ROFOs are much more flexible from a shareholders’ perspective in providing liquidity as a third party offer is not required prior to a shareholder exercising its rights under ROFO provisions.

- **Drag-Alongs**: be careful that the terms and conditions applicable to any offer are fairly “vanilla” and, for example, do not or cannot contain restrictive covenants against such an investor; can only provide for pro rata or “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.)

- **Tag-Alongs**: consider whether a tag-along on sales by the founder is advisable.

- **Foreign ownership restrictions**: consider the implications of exercising ROFOs, ROFRs or other exit rights or generally investing in corporations subject to foreign ownership constraints (e.g. those subject to the Telecommunications Act) since the potential market is much smaller for a sale and a U.S.-controlled 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, 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 and their shareholders.

- **Registration rights**: rights to require an IPO or share listing 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 an attractive exit strategy.

- **Confidentiality provisions**: ensure the ability to disclose confidential information to investors or potential investors in 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 to avoid restrictions on the business operations of portfolio companies of the private equity fund.
- **Financing and capital calls**: never provide for unlimited capital calls. However, ensure you have pre-emptive rights over new share issuances to allow you to maintain your percentage holding.
- **Governance rights**: having a veto on the business plan and extraordinary matters 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, or where confidentiality is of concern.
- **Transfer Rights**: ensure that permitted transferees include your limited partners and other funds managed by the same managers.

## Exit Alternatives

The limited time horizon of private equity investors makes it imperative that a USA should clearly set out a variety of convenient ways for such investors to “exit” the company.

### Sale to a Third Party (Private Sale/Controlled Auction)

A private sale to a third party is an important exit option. While a private sale might seem more informal that some other options, process is still very important. Typically a controlled auction is used because it allows for vendor control of the process while also providing a forum for attracting multiple offers.

In a private sale situation, sellers and potential acquirors will not infrequently have divergent views about the company’s value. Where agreement cannot be reached, the gap can often be fairly and effectively bridged by a deferred payout and/or a properly-constructed earn-out provision.

In addition, the means of protecting a seller under a purchase and sale agreement are always important. These include:

- Avoiding joint liability on representations, warranties and indemnities;
- Minimizing the scope and nature of the representations and warranties;
- Avoiding subjective warranties – including, in particular, the “full disclosure” (“10b-5” type) warranty;
- Use of materiality and knowledge qualifications;
- Precluding actions for rectification or rescission, if possible;
- Minimizing conditions of closing and trying to make them as objective as possible and within reasonable control (avoid offering “releases” from directors and officers). Avoid allowing financing or “due diligence” outs; try to narrow the MAC condition of closing by use of exclusions from the MAC;
- Trying to provide for alternatives (e.g. if it does not prove possible to obtain consent to the assignment of a contract, an alternative arrangement which is not materially different may be provided);
• Using an anti-sandbagging provision to the effect that a buyer’s knowledge of a breach of any of the representations and warranties precludes a post-closing claim;
• Avoiding or limiting “no liability” warranties (possibly by limiting them to balance-sheet, GAAP-type liabilities);
• Insisting upon short survival periods for representations and warranties;
• Using deductibles (or de minimis) thresholds for damage claims (possibly on both an individual and aggregate basis);
• Always insisting upon a maximum or cap on liabilities (as a percentage of the purchase price actually received);
• Considering an express obligation to mitigate damages and the set off of tax benefits, insurance proceeds and similar amounts from damage awards; and
• Providing for the use of representation and warranty insurance.

Use of Representation and Warranty Insurance

Representation and warranty insurance ("RWI") has become a mainstream transactional consideration. RWI allows private equity investors, as sellers, to cap their indemnification exposure and permits the disbursement of the proceeds of a sale (net of any escrow requirements) to the investor’s securityholders without risk of repayment arising from post-closing indemnification claims. RWI may also be used as a tactical tool in a controlled auction process.

For bidders, the use of RWI allows it to accept more ‘seller-friendly’ deal terms to make its bid more attractive to sellers and, at the same time, limit its risk exposure, to increase the success of its bid. For sellers, it is a means to a quick and clean exit as RWI gives them certainty in respect of their liability from breaches of the representations and warranties and provides an alternative means of recourse for buyers. Although the cost of RWI may vary depending on if it is a 'buy-side' vs. a ‘sell-side’ policy and the amount of retention (deductible) applicable, they currently range from approximately 2% to 4% of the coverage limit with a retention or deductible that ranges from approximately 1% to 3% of the transactional value with a drop-down in such retention amount typically 12-18 months after the effective date of the policy. This retention amount, representing the loss that the buyer must suffer first before a claim for coverage can be made under the RWI, is typically shared between the buyer and seller with the seller placing a portion of the retention amount in an indemnity escrow, representing potentially the seller’s maximum exposure for the breach of certain representations and warranties. It is also possible where a seller has significant leverage (e.g. in some auctions) for a seller to impose a ‘public-style’ deal with no indemnification obligations after closing and no liability for any retention.
Restrictions on Sales to a Third Party

Under a shareholders’ agreement, the right of any shareholder to sell to a third party is invariably subject to rights of other shareholders. These can take the form of ROFRs, ROFOs, tag-alongs and drag-alongs, as discussed above. A buyer may require an incumbent shareholder to retain an equity investment in the company or, more often, to provide financing by way of “vendor take-back” (i.e. debt held by the seller).

Sale to Management (MBO)

The management buyout ("MBO") is one type of sale to a third party. In some cases, particularly in a situation where bank financing is unavailable, a private equity investor will agree to finance such a buyout, essentially converting its equity into a more secure debt obligation (that is, vendor financing) that may also provide regular cash flow as the debt is repaid.

Sale to Other Shareholders

Selling out to other shareholders is a common exit strategy for private equity investors. Such a sale can of course happen, even if it is not specifically intended, when the other shareholders exercise their rights under a ROFR or ROFO. The USA can contain additional mechanisms that are intended to facilitate the transfer of shares to or from other existing shareholders, often as a form of exit strategy. Among these are “put” and/or “call” options and “shotgun” arrangements.

Put or Call Option

“Put” (the right to sell) or “call” (the right to buy) options can be exercisable (i) at any time, (ii) after a period of time, or (iii) upon the occurrence of a specified event or events. A “put” option may also provide that it can be triggered as against all other shareholders on a pro rata basis or alternatively as against the corporation. It is therefore important to consider who is the appropriate buyer – the corporation or the other 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 in the corporate statute and to any restrictive covenants in loan agreements or other contracts. Sometimes where such statutes would prohibit the exercise of a put right, an alternative approach is to sell the company and drag along the other shareholders to ensure a timely exit is possible.

Shotgun

A shotgun is a contractual mechanism permitting one shareholder to 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 well where there are two roughly equal shareholders of similar financial capability and equal motivation (for example, where neither is under any duress). Because shotgun provisions are usually considered quite draconian, qualifications are often inserted to limit their
use. For example, there will often be a “honeymoon period” (say, of three years) after the private equity investment is made, during which the shotgun cannot be exercised. The Court of Appeal in Ontario, in *Western Larch Limited v Di Poce Management Limited* (2013), ONCA 722, made it clear that enforceability of such provisions require strict (though not perfect) compliance with the provisions in the applicable agreement. To determine if a party has been ‘sufficiently’ compliant, the court will look at the language in the agreement and the commercially reasonable expectation of the parties given the facts of case.

Shotguns are rarely provided in Canadian private equity transaction documentation. Private equity firms generally see little appeal in the prospect of being forced, at a time not of their choosing, either to exit the company or to acquire a larger ownership stake that they are unlikely to need or want. While in the case of an investment in a small, closely-held company or a struggling turn-around prospect it might seem relatively unlikely that other shareholders would have the wherewithal to push a private equity investor out by means of a shotgun, it is worth bearing in mind that there are “shotgun funds” that specialize in financing such efforts. In any event, if a shotgun is to be included in a USA, at a minimum the agreement should make it clear that the private equity investor, if it exits in this way, will not be constrained by non-competition and confidentiality requirements.

**Sale to a Rival Company (Industry Consolidation)**

In some circumstances, a private equity investor will find it advantageous to cause the company to merge with a rival company or other company, taking a small stake in the combined entity and, in many cases, some cash as well. An “industry consolidation” may have the effect of shifting the nature of the investment in a manner beneficial to the private equity investor. That is, while the entity in which the original private equity investment was made may have been a small start-up or financially troubled, the merged entity will often be a much larger and stronger business whose stability may be attractive to the private equity firm’s own shareholders. Such a consolidation might take the form of a stock-for-stock transaction alleviating the need for cash or debt financing to fund the acquisition, and allowing for tax deferral strategies.

**Sale to the Public (IPO)**

A very common feature of USAs involving private equity investors are so called “registration rights” or “prospectus rights”. These allow the shareholder to force a private company to undertake an Initial Public Offering (“IPO”) or to force a public company to list the shares of private equity investors for trading after a given period of time in specified circumstances.

A common share IPO is rarely a 100% exit for a significant investor. Even when a substantial block of existing shares can be sold, it may need to be shared between all would-be sellers, unless the private equity investor has pre-negotiated preferred status on the exit. Needless to say, regulators, underwriters and prospective
investors 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.

Exiting Through an Asset Sell-off

Another exit strategy is to sell off assets (often from among the company’s “crown jewels”) in order to improve the return on the private equity investor’s investment, allowing it to exit even though the value of the company’s shares has not appreciated. Although not common, a USA might provide for the right of a significant shareholder to force the sale of a particular business and related assets. Without the co-operation of incumbent management and other directors, however, this could prove very difficult to implement.

Exiting Through a Plan of Arrangement Process

Just as an initial investment may be accomplished with the use of a plan of arrangement under corporate law (see the “Plan of Arrangement” section, above) so the exit may also be carried out by way of a plan of arrangement. The Canada Business Corporations Act (“CBCA”), for example, provides that where it is not practicable for a corporation that is not insolvent to effect a fundamental change in the nature of an “arrangement” under any other CBCA provision, the corporation may apply to a court for an order approving an arrangement proposed by the corporation. The plan of arrangement allows for much flexibility, including allowing the court to deal with optionholders as part of the sale process.

Exiting Through an Insolvency Process (Distressed M&A)

A business environment with declining revenues, extremely tight credit markets and lower valuations may force some private equity investors to consider scenarios governed by bankruptcy and insolvency laws. In many cases, equity investments (common or preferred) will have little or no value, leaving debtholders to realize only a fraction of what they are owed, possibly in the form of equity of a restructured entity.

In Canada, there are basically four formal processes through which a financially distressed business can be reorganized or sold:

- **Arrangement** under the Companies Creditors’ Arrangement Act (“CCAA”);
- **Proposal** under the Bankruptcy and Insolvency Act (“BIA”);
- **Receivership** under the BIA; and
- **Bankruptcy and liquidation** under the BIA.
The CCAA process is the most flexible in practice and permits the debtor to stay in possession and operate its business under the protection, supervision and control of the court (typically through a monitor) and ultimately the sale of the business as a going concern. A vesting order of the court enables a buyer to acquire assets free and clear of any liens and encumbrances. We have seen more U.S. acquirors using the CCAA process and a “stalking horse bid” in order to acquire a troubled business in Canada in recent years. The sales process may also be conducted by the debtor-in-possession (“DIP”) lenders and senior secured lenders with the involvement of the monitor.

A proposal under the BIA is also a debtor-in-possession process, similar to the CCAA for restructuring but is more mechanical and less flexible than the CCAA process. Generally asset sales as a going concern are more difficult.

A receivership under the BIA puts a court-appointed receiver in possession of the assets under the control and direction of the court. It is generally not as flexible as CCAA or a proposal under the BIA. A straight bankruptcy or liquidation is the least flexible option.

### Executive Employment and Compensation Issues

Employment law and compensation issues are particularly important in many private equity investment situations. It can be crucial to retain existing management where (as is often the case) the business sector in which the company operates lies outside the core expertise of the private equity firm. It can be equally important to ensure that contractual arrangements are made to limit the liabilities associated with terminating such employees’ employment, should the relationship breakdown.

### Employment Law Issues

U.S. investors should be aware that Canadian employment law differs significantly from its U.S. counterpart. One of the most significant differences between the two countries is that Canada has no concept of “employment at will”. This means that employment cannot be terminated (without cause) unless the required notice is given (or, alternatively, pay in lieu of that notice is paid). While minimum notice (and, in some cases, severance pay) requirements are established by provincial employment standards legislation, an employee’s entitilements upon termination of employment without cause will not be limited to such minimum statutory requirements unless the employee has entered into a written employment agreement which provides that the employee will only be entitled to such minimums upon termination of employment. In no case may a court, or a written employment contract, provide for less than the statutory minimum.

Absent an enforceable contractual termination clause, employees in Canada are entitled to “reasonable notice” of termination based on either the common law or the civil law of Quebec. Common and civil law requirements generally exceed the
statutory minimums described above and are determined on an individual basis, depending on a variety of individual factors, including the employee’s age, length of service and position, among other things. Payment in lieu of reasonable notice may be provided; however, all forms of compensation and benefits must be continued throughout the employee’s notice period.

For the sake of certainty and clarity, and to avoid costly litigation, it is highly advisable to have senior management sign written employment agreements which clearly outline their entitlements upon termination.

Canadian courts also tend to frown on post-employment non-competition covenants. To be enforceable, such covenants must be drafted narrowly, so as to minimally impair the ex-employee’s ability to use his or her knowledge and skills. Moreover, the Supreme Court of Canada has held that restrictive covenants in employment contracts must be drafted very clearly; our courts will not rewrite an ambiguously drafted non-compete or “read down” a covenant that was drafted in an overly broad fashion. In other words, the courts in Canada do not practice the “blue-pencilling” that is common in the U.S.

Executive Compensation Issues

It is customary for executive compensation to be based on both short-term and long-term incentives and to include a combination of equity incentive plans, non-equity incentive plans, salary, perquisites and pension benefits. Form 51-102F6, published by the Canadian Securities Administrators, contains requirements on disclosure of executive compensation similar to those followed by the U.S. Securities and Exchange Commission since 2006.

Briefly, Form 51-102F6 requires companies to identify their three most highly compensated executive officers on the basis of total compensation, with certain prescribed exclusions such as pension value. In particular, the named executive officers must disclose share-based awards, option-based awards, non-equity incentive plan compensation value and total compensation for the three most recently completed financial years. In a private equity context, options are of particular interest and therefore it is important to note that Form 51-102F6 states that both share-based awards and option-based awards must be disclosed on a “grant date fair value” basis, with any discrepancy between amounts so determined and “accounting fair value” (as defined in Section 3870 of the CICA Handbook) disclosed and explained in a footnote.

For more information about executive compensation rules in Canada, please refer to Stikeman Elliott’s Executive Compensation in Canada.
About the Firm

When Heward Stikeman and Fraser Elliott first opened the firm’s doors in 1952, they were united in their pledge to do things differently to help clients meet their business objectives.

In fact, they made it their mission to deliver only the highest quality counsel as well as the most efficient and innovative services in order to steadily advance client goals.

Stikeman Elliott’s leadership, prominence and recognition have continued to grow both in Canada and around the globe. However, we have remained true to our core values.

These values are what guide us every day and they include:

- Partnering with clients – mutual goals ensure mutual success.
- Finding original solutions where others can’t – but they must also be grounded in business realities.
- Providing clients with a deep bench of legal expertise – for clear, proactive counsel.
- Remaining passionate about what we do – we relish the process and the performance that results from teamwork.

A commitment to the pursuit of excellence – today, tomorrow and in the decades to come – is what distinguishes Stikeman Elliott when it comes to forging a workable path through complex issues. Our duty and dedication never waver.

This is what makes Stikeman Elliott the firm the world comes to when it counts the most.