FEATURE ARTICLES

Doing a Deal in Canada? 10 Things You Should Know

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Toronto's hosting of the 2011 ABA Annual Meeting brings a focus on Canada. Many lawyers will travel to Canada for the meeting. After passing through Canada customs and immigration, they'll settle into their hotel and may feel like they're in a large US city ... many familiar stores and hotel names. With Toronto nestled on the shores of Lake Ontario, it might feel a bit like Chicago; some similar architecture too. A foreign country, but it might not feel too unfamiliar.

For the American deal lawyer experienced in United States-Canada cross-border transactions, Canada likely feels quite familiar. The deal culture is very similar to the US. All provinces except Quebec have the English tradition of the common law (Quebec's legal regime is based on the civil law system) and, for the most part, the form of agreement typically used to acquire the assets or shares of a Canadian company looks and feels like a US form of agreement. Indeed, many Canadian deal lawyers find the model asset and stock purchase agreements produced by the Mergers and Acquisitions Committee of the ABA's Business Law Section to be useful tools in their drafting toolkit.

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But, if you're in Toronto for the Annual Meeting and explore the city, you'll discover points of difference which set Canada apart from the United States and Toronto apart from other large North American cities. Likewise, if you get involved in a Canadian or cross-border deal, you'll discover that some things are done a bit differently in Canada. So, we thought we'd take this opportunity – with the ABA Annual Meeting being held in Toronto – to highlight ten things about Canadian deal practice and the legal environment that you should know if you have a deal in Canada.

M&A Activity is Regulated at Several Levels

M&A activity in Canada is regulated under each of the following levels:

- *Corporate Laws.* Canadian corporations may be incorporated under the federal *Canada Business Corporations Act* ("CBCA") or one of the similar provincial or territorial business corporations acts. These statutes regulate a variety of ordinary and extraordinary corporate transactions (*e.g.*, statutory amalgamations (similar to a Delaware merger) and "plans of arrangement"). Extraordinary corporate transactions must be approved by a special resolution of shareholders (typically two-thirds of the votes cast). Shareholders generally have the right to dissent from extraordinary corporate transactions and demand payment of the "fair value" of their shares (as determined by a court if necessary). Canadian courts have broad remedial powers to intervene in respect of transactions that are oppressive or unfairly prejudicial to, or that unfairly disregard the interests of, shareholders.
- *Securities Laws.* Securities regulation in Canada is the responsibility of the provinces (10) and territories (3). Each province and territory has its own legislation and securities regulatory authority that regulate, among other things, take-over bids (the Canadian version of a tender offer). The Provinces of Ontario and Quebec have additional rules (including approval by a majority of the minority shareholders and independent valuation of the subject matter of the transaction) designed to ensure fair treatment of minority shareholders in connection with certain types of transactions involving a corporation and its "related parties" (which include shareholders owning 10% or more of the voting securities of the corporation).

  The provincial and territorial securities regulatory authorities coordinate their activities through the Canadian Securities Administrators (CSA), a forum for developing a harmonized approach to securities regulation across the country. The CSA has developed a system of mutual reliance pursuant to which one securities regulatory authority acts as the lead authority for reviewing regulatory filings of "reporting issuers" (*e.g.*, Canadian public companies).

  The Ontario Securities Commission (OSC) is generally regarded as the lead securities regulatory authority in Canada.
- *Stock Exchange Rules.* The two principal stock exchanges in Canada are the Toronto Stock Exchange (TSX) (senior market) and the TSX Venture Exchange (junior market). These exchanges regulate selected aspects of M&A activity.

Acquiring Control of a Public Company

Control of Canadian public companies typically is acquired through one of two structures – a take-over bid or a plan of arrangement:

- In a *take-over bid*, the acquirer offers to acquire a prescribed percentage of the target's outstanding voting or equity securities. A "take-over bid" results when the securities subject to a bid combined with the securities owned by the bidder and parties acting jointly and in concert with the bidder constitute 20% or more of the outstanding securities of any class. The offer can be in cash, securities, or a combination of both and must be left open for at least 35 days.

  In a bid for all outstanding shares, if the bidder acquires 90% or more of the shares available, the remaining shares can be acquired through a forced statutory transaction known as a "squeeze-out." If the bidder acquires at least 66 2/3% of the voting securities of the target, it may implement a second stage going-private transaction, for example, by way of plan of arrangement.

- A *plan of arrangement* is a one-step corporate transaction that requires approval of the target's board, shareholders, and the court. The structure of the plan (*e.g.*, three corner merger, capital reorganization, etc.) generally will be determined based on criteria including specific tax results desired by the acquirer, the need to deal with debt securities or convertible securities such as options and other rights, and regulatory considerations. As noted above, a plan of arrangement must be approved by two-thirds of the shareholder votes cast and shareholders generally have the right to dissent and demand payment of the "fair value" of their shares. Depending on the circumstances, Canadian securities regulation may impose a disinterested minority vote requirement.

The *Ontario Securities Act* provides for an early warning disclosure requirement that is triggered when an acquirer (together with its affiliates, associates, or persons acting jointly or in concert with the acquirer) acquires beneficial ownership of, or the power to exercise control or discretion over, more than 10% of the voting or equity securities of any class of the target. Upon reaching the 10% level, the acquirer is obligated to immediately issue and file a press release containing certain prescribed information and file a report. The acquirer is subject to a trading moratorium ending one business day after the required report is filed.

Further early warning disclosure requirements are imposed whenever ownership or control of securities of the target are increased by an additional 2% or more or there has been a change in the previously reported information.

Directors Owe Fiduciary Duties to the Corporation, Not Just the Shareholders

In 2008, the Supreme Court of Canada (SCC) clarified its thinking with respect to the nature and scope of directors' duties in the context of a change of control transaction where the interests of securityholders (in that case, shareholders and debentureholders) are affected differently.

The case (*BCE Inc. v. 1976 Debentureholders*) involved a challenge by a group of Bell Canada debentureholders to the proposed acquisition of BCE Inc. by a consortium of purchasers pursuant to a plan of

arrangement. The debentureholders objected to the arrangement and, among other things, sought relief under the oppression remedy of the CBCA.

The SCC reaffirmed its earlier decision in *Peoples Department Stores Inc.* that the fiduciary duty of the directors of a corporation is to the corporation, an entity separate from its stakeholders. The SCC noted, in particular, that "corporation" does not mean "shareholders," thereby effectively rejecting the principle in the *Revlon* line of cases in the United States that, in change of control situations, the directors have a duty to maximize shareholder value.

The SCC went on to say, however, that in considering what is in the bests interests of the corporation, directors may look to the interests of, among others, shareholders, employees, creditors, consumers, governments, and the environment to inform their decisions. So, while directors of Canadian corporations are obligated to act in the best interests of the corporation, and not of any particular group of stakeholders, as a practical matter, in change of control circumstances, they make shareholders and shareholder value their primary focus since shareholder approval is critical to whether a change of control transaction will or will not proceed.

Some Investments Are Subject to Federal Government Review

The *Investment Canada Act* requires that any non-Canadian that acquires control of a Canadian business (whether or not that business is controlled by Canadians prior to the acquisition) must file either a notification or an application for review. For the purposes of the Act, a non-Canadian includes any entity that is not ultimately controlled or beneficially owned by Canadians.

If an investment meets the financial thresholds for review, a review application must be filed and a determination made by a Minister of the Federal government whether the transaction is of "net benefit to Canada." The review thresholds are complex. Generally, a direct investment (*i.e.*, the acquisition of the shares or assets of a Canadian corporation) by a WTO Investor (*i.e.*, controlled by persons from countries that are members of the WTO) is reviewable if the target has assets equal to or exceeding C$312 million in 2011 (adjusted annually). Indirect investments by WTO Investors are not reviewable, except as noted below.

Special rules and significantly lower thresholds apply, however, in respect of direct and indirect acquisitions of so-called "cultural" businesses (*e.g.*, broadcasting, film, video, audio, books, and magazines). Special rules also permit a national security review, without regard to the value of the target's assets.

An investment that is not reviewable must be notified. Notification is made by completing a simple two-page form which can be filed any time prior to or within 30 days of the closing.

Employees Are Not Employed "At Will"

There is no employment "at will" in Canada, so it can be costly to restructure a business or otherwise terminate employees.

Each province in Canada has employment standards legislation that sets out the minimum amount of notice that an employer must provide to an employee in order to dismiss the employee without cause. In most provinces, one week per year of service must be provided, up to a maximum number of weeks. For example, Ontario's employment standards legislation provides for a maximum of eight weeks of notice, or pay in lieu of notice. Ontario's legislation also requires most employers to provide severance pay in the amount of one week of pay per year of service,

up to a maximum of 26 weeks. No other province provides for severance pay.

However, the entitlements to notice of termination and severance pay established by legislation are minimum standards only – greater obligations may be imposed by the terms of an employment agreement or, in the absence of an agreement, by common law. If there is no written employment agreement, an employee is entitled to reasonable notice at common law, which is usually in excess of the statutory minimum entitlements to notice and severance pay. The determination of reasonable notice varies from case-to-case and is dependent upon a number of factors including the employee's age, position and responsibilities, length of service, and remuneration. Reasonable notice at common law can be very long and because there is no set formula, difficult to quantify in a transaction. A 24-month "cap" on notice has been tacitly acknowledged by some courts and is rarely exceeded. This level of award is generally reserved for employees with long service, who are at a professional or managerial level.

In a share transaction, the responsibility for notice and severance will remain with the acquired company and, therefore, pass to the purchaser who will be responsible for an employee's previous service with the acquired company. In an asset transaction, an employee's employment typically is terminated on closing and the vendor remains responsible for notice and severance costs. However, it is common for asset purchasers to offer employment to the vendor's employees and, if that offer is accepted, the purchaser becomes liable for notice and severance obligations. The rules are different and more complex in a unionized environment.

Deal Terms May Differ

When negotiating a purchase and sale agreement involving Canadian parties, US deal lawyers will confront many of the same issues arising in a US transaction, whether the negotiations relate to the scope of the representations and warranties and the use of materiality and knowledge qualifiers, the conditions precedent to closing, or the procedures for dealing with post-closing adjustments to the purchase price and delivery of closing financial statements.

Where you are likely to see differences, however, are in the following areas:

- Indemnity caps are typically higher in Canada than in the US. It's not uncommon for Canadian purchasers to insist on a cap in excess of 50% of the purchase price and in many cases up to 100% of the purchase price.
- Holdbacks in support of indemnity claims are not common in Canadian deals. In many cases, vendors require the purchaser to rely on the vendor's unsecured covenant to indemnify, sometimes supported by a related party guarantee in appropriate cases.
- Exceptions to the foregoing often involve Canadian private equity investors, who, like their US counterparts, understand the need for low indemnity caps (perhaps 10-15% of the purchase price), supported by holdbacks deposited in escrow, thereby permitting a private equity vendor to disburse sales proceeds to its limited partners immediately following closing with little or no risk of a clawback.
- General survival periods for representations and warranties are longer in Canada (often 18-24 months)

and it is not uncommon to have three to five year survival periods for specific matters such as pensions and environmental claims and even longer periods for claims relating to title.

- Earnouts are used much less frequently in Canadian deals, although in the writers' experience, they do show up, particularly in private equity deals, if the parties are having trouble bridging the gap on price.
- Transaction legal opinions, once a standard closing condition in Canadian M&A transactions and often the subject of heated negotiation between legal counsel, are becoming less and less common in Canada.

These and other trends are detailed in the *2010 Canadian Private Target M&A Deal Points Study* produced by the Mergers and Acquisitions Committee of the ABA's Business Law Section.

Some Acquisitions Require Clearance of Tax Authorities (or Partial Hold-Back of the Purchase Price)

Where a non-resident of Canada disposes of "taxable Canadian property" ("TCP"), certain obligations are imposed on the vendor and purchaser under section 116 of the *Income Tax Act* (Canada). The non-resident vendor is generally required to obtain a compliance certificate from the Canada Revenue Agency ("CRA") in respect of the subject disposition. Under section 116, if a compliance certificate is required and the purchaser does not make any withholdings, the purchaser is generally liable to pay the Minister an amount equal to 25% (*e.g.*, in the case of shares and other non-depreciable assets) or 50% (*e.g.*, in the case of depreciable property or real property inventory) of the purchase price. These provisions are designed to ensure that the non-resident vendor pays Canadian income tax resulting from the disposition.

The section 116 rules are complex and a number of exemptions are provided. Notably, shares of private Canadian companies are generally not TCP provided the shares have not, at any time during the 60 months preceding the relevant disposition, derived more than 50% of their value from one or any combination of (i) real or immovable property situated in Canada, (ii) Canadian resource properties, (iii) timber resource properties, and (iv) options or interests in property described in (i) - (iii).

A purchaser is generally responsible for withholding and remitting the appropriate amount of tax on a purchase of TCP from a non-resident, even where, for example, the purchaser incorrectly determines that the shares are not TCP. To manage the risk, a purchaser can perform due diligence, engage a valuator, and/or obtain appropriate representations, warranties and indemnities, or can eliminate the risk by requiring a section 116 certificate from the vendor.

Antitrust Notification May Be Required and There May Be a "Second Request"

The *Competition Act* contains a robust pre-merger notification regime. Generally, the acquisition of voting shares of a Canadian operating business (or of a corporation that controls a Canadian operating business) will be notifiable if the following three tests are satisfied

- A "size-of-the-parties" test, which requires that the parties to a transaction, together with their worldwide affiliates have assets in Canada or annual gross revenues from sales in, from, or into Canada exceeding C$400 million.
- A "size-of-transaction" test, which requires that the target (or entities

controlled by the target) have assets in Canada or annual gross revenues from sales in or from Canada exceeding C$73 million in 2011 (adjusted annually).

- An ownership test, which requires that following completion of the transaction, (a) the acquirer (and its affiliates) will own more than 20% of the target's voting shares, if the shares are publicly traded (35% in the case of a private company) or (b) if more than 20% (public company) or 35% (private company) of the target's voting shares already are owned by the acquirer (and its affiliates), the acquirer (and its affiliates) will own more than 50% of the voting shares.

Similar thresholds are applicable to asset transactions, amalgamations (similar to Delaware mergers) and combinations.

Much like in the US, notifiable transactions are subject to a 30-day no-close waiting period, which can be extended by the Commissioner of Competition issuing a supplementary information request requiring that the parties provide additional information.

Tax Rules Impact the Investment Structure

When structuring a Canadian acquisition, a foreign buyer should bear in mind the following three tax issues:

- *First*, when acquiring shares in a Canadian target, the foreign buyer will generally want to incorporate a Canadian acquisition vehicle so that the full purchase price can be repatriated to the foreign jurisdiction free of Canadian withholding taxes. Corporations can easily be formed under Canadian Federal law or the law of any province. In some jurisdictions, at least 25% of the directors must be residents of Canada.

- *Second*, if the foreign buyer wants to have a flow-through tax entity, Canada does not have the concept of a limited liability company. Instead, the choices for flow-through entities are either a partnership (typically a limited partnership) or an unlimited liability company ("ULC"). ULCs often are used as a vehicle for US entities to make investments in Canada because the entity is treated as a corporation for Canadian tax purposes but a check-the-box, flow-through entity for purposes of US income tax laws. Thus, from a US perspective, any losses of the ULC could be used to off-set any income of the US parent for US tax purposes. The 2010 amendments to the Canada-US tax treaty have complicated the use of ULCs for US investors.

- *Third*, a foreign buyer must be mindful of complying with Canada's thin capitalization rules which require a debt-equity ratio of not more than 2:1. Otherwise, a component of the inter-corporate interest expense will be disallowed in computing the income of the Canadian subsidiary.

Special Considerations for Pension Plans

Although Canada has a government-funded pension plan, benefits under the plan are limited so many employers offer participation in private plans to their employees. But, unlike ERISA in the US which provides one uniform set of rules for all pension plans, company sponsored pension plans in Canada are primarily subject to regulation by the federal *Income Tax Act* and provincial minimum pension standards legislation. These two

primary sources of regulation and the policies and technical interpretations that support them create significant complexity which makes administration of Canadian pension plans onerous.

In the context of an M&A transaction, the complexities of the Canadian pension regulatory regime are brought into sharp focus. Through minimum pension standards legislation, the federal and provincial jurisdictions stipulate different requirements in the context of a sale of a business. These include rules relating to recognition of past service, vesting and benefit entitlements, terminations of plans, and transfers of assets. Recent judicial decisions regarding the potential liability associated with funding deficits, prior plan terminations, and asset movements have added complexity, making the coverage of pension plan arrangements a significant feature of deal documents.

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