private equity in Canada

mcmillan

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introduction

Canada remains an attractive source of investment opportunities for foreign private equity investors, particularly US investors. While there have been a number of very large Canadian private equity transactions in recent years, most Canadian transactions are in the $15-50 million dollar range.

Previously, the impact of the global credit crisis on the availability of third party financing appears to have made these mid-market sized transactions attractive to medium to large US funds, since those funds are able to complete the transactions without third party financing. As the credit markets have stabilized, the funds have gone back and started to insert leverage into these deals.

The Canadian private equity market is attractive for a variety of reasons including:

- **Favorable Market Conditions.** While the number and size of Canadian private equity funds has increased (and a number of large Canadian pension plans have direct investment programs), the Canadian market is still under served versus the US market. Infrastructure renewal projects are one significant area expected to drive private equity investment.
- **Economic Performance.** The Canadian economy has performed well relative to the US economy in recent years, although the positive effect of this performance may be offset in part by the stronger Canadian dollar relative to the US dollar.
- **Jurisdictional Risk and Compatibility.** Canada offers low jurisdictional risk because of the relative similarity of the Canadian and US legal systems. In addition, most standard US deal terms (e.g., liquidation preferences, registration rights and governance) can be implemented in Canada with relatively few changes.

what follows is:

- An overview of the relevant Canadian legal framework; and
- A summary of certain Canadian legal/investment considerations.

legal framework

corporate statutes

Canadian corporations may be formed and operate under a federal, provincial or territorial corporate statute. These statutes regulate certain corporate transactions (including statutory amalgamations and plans of arrangement) and extraordinary transactions (including the sale, lease or exchange of all or substantially all of the property of a corporation, liquidation and dissolution). Most of the statutes provide for shareholder approval of these transactions by special resolution (66 2/3% of the votes cast) and rights to dissent and demand fair value for shares affected by these transactions. Canadian courts also have broad remedial powers under corporate statutes to intervene in transactions that are oppressive or unfairly prejudicial to or that unfairly disregard shareholder interests.

securities regulation

Canadian publicly traded companies are also regulated under provincial and territorial (not federal) securities laws which regulate, among other things, public securities offerings, continuous disclosure, insider trading and tender offer transactions. In addition, there are two principal stock exchanges in Canada, the Toronto Stock Exchange (TSX) (senior market) and the TSX Venture Exchange (junior market), which also regulate Canadian public companies.

Certain of the provinces have additional rules (including approval by a majority of the minority shareholders and independent valuations of the subject matter of the transaction) designed to ensure fair dealing in the treatment of minority shareholders of publicly-traded companies in certain types of transactions involving controlling shareholders or "related parties" (which include shareholders owning 10% or more of the voting securities of a corporation). The fair dealing rules also apply to "going private" transactions.

going private transactions – Multilateral Instrument 61-101

- MI 61-101 attempts to ensure fair dealing in the treatment of minority shareholders in connection with transactions whereby minority holdings in Canadian public companies are eliminated by a controlling shareholder (these so-called "going private" transactions may be effected by way of a first stage transaction consisting of an amalgamation or a statutory arrangement or a second stage transaction following an initial tender offer).
- The Rule requires a formal valuation to be prepared by an independent valuer with respect to the shares held by minority shareholders. The Rule does not permit downward adjustment to reflect liquidity or lack thereof, the effect of the transaction on the minority's shares or the fact that the shares do not form part of a controlling interest. The formal valuation report is required to be included in the disclosure material relating to the transaction.
- The Rule effectively requires approval by a majority of the "minority" or disinterested shareholders (either by way of a minimum tender condition or by way of a shareholder vote, depending on the structure of the transaction).
- The Rule recommends the use of a special committee of independent directors to carry out negotiations with the controlling shareholder or "related parties" and provides that it is essential, in connection with the disclosure, valuation, review and approval processes, that all security holders be treated in a manner that is fair and perceived to be fair.

legal/investment considerations

ownership restrictions

Canada imposes certain restrictions on foreign ownership including:

- **Investment Canada Act ("ICA").** The acquisition by a non-Canadian of "control" of a Canadian business which exceeds certain prescribed monetary thresholds is reviewable under the ICA and subject to approval by the federal Minister of Industry or the Minister of Heritage (depending on the nature of the business of the Canadian company). Transactions below the applicable threshold are subject to a "tick-the-box" notification process. For purposes of the ICA, the acquisition of one-third or more of the voting shares of a Canadian corporation will be presumed to be an acquisition of control unless it can be established that, on the acquisition, the corporation is not controlled in fact by the acquirer through the ownership of voting shares. In addition, under the ICA, the federal Ministers of Industry and of Public Safety and Emergency Preparedness have the discretionary power to review any investment by a non-Canadian (including investments below the control threshold) where there are reasonable grounds to believe that the investment could be injurious to national security.

- Other Restrictions. Certain other federal statutes limit foreign ownership in specified industries, such as financial services, broadcasting and telecommunications (e.g., non-Canadians are not permitted to own more than one-third of the voting shares of a holding company which has a subsidiary operating company licensed under the *Broadcasting Act*).

In addition, a private equity investment which constitutes a merger may also be subject to regulation under the *Competition Act ("CA")*. Under the CA, the term "merger" is broadly defined to include the acquisition or establishment, whether direct or indirect, and whether by purchase of shares or assets, by amalgamation or by combination or otherwise, of "control over a significant interest" in the whole or a part of a business. Pursuant to the CA, parties to mergers which meet certain size thresholds must notify the Canadian Competition Bureau before completing the merger.

income tax considerations

The following Canadian income tax rules will be relevant to all foreign private equity investors:

- Capital Gains on Sale of Equity Interest. In general, foreign investors are not subject to Canadian tax on capital gains realized on a sale or other disposition of shares of a Canadian company unless such shares have at any time in the 60 months preceding the sale, derived their value principally (i.e. more than 50%) from real property situated in Canada. Many of Canada's income tax treaties, including the *Canada-United States Income Tax Convention* (the "US Treaty"), operate to narrow the scope of the above-noted test to the point in time that the subject shares are sold. Certain tax reporting and compliance requirements may apply to the sale.
- Withholding Tax. Dividend payments made by a Canadian portfolio company to a foreign equity investor are generally subject to a 25% withholding tax while most interest payments between arm's length parties are exempt. Withholding taxes (where applicable) may be reduced by virtue of an income tax treaty. Under most of Canada's income tax treaties, the withholding tax rate on interest otherwise subject to withholding tax is reduced to 10% (a complete exemption is available in most cases under the US Treaty to qualifying recipients). The withholding tax rate on dividends is generally reduced to 15%, subject to a further reduction to 5% or 10% if certain share ownership (or similar thresholds) are satisfied. For example, under the US Treaty, the dividend withholding tax rate is 5% if the eligible US resident shareholder owns at least 10% of the voting stock of the Canadian company. Additional exemptions from Canadian withholding tax on dividends may be available to pension funds or charitable organizations that are exempt from tax in the jurisdiction in which they are resident.
- Management and Administration Fees. Management and administration fees paid by a Canadian resident to an arm's length non-resident for services provided by the non-resident in the ordinary course of the non-resident's services business are not subject to Canadian withholding tax. A 25% withholding tax can apply when these conditions are not met, although exemptions are available under most of Canada's treaties (including the US Treaty) provided the treaty country resident does not render the subject services through a permanent establishment in Canada.
- Thin Capitalization Rules. Thin capitalization rules prohibit Canadian companies from deducting interest on the portion of interest-bearing loans from specified non-residents that exceeds two times the "tax equity" of the specified non-residents in the Canadian company (generally, unconsolidated retained earnings plus outstanding share capital and contributed surplus attributable to the specified non-residents). For this purpose, a "specified non-resident" is any

non-resident that holds shares representing 25% or more of the votes attached to, or the fair market value of, the outstanding shares of the Canadian company or that does not deal at arm's length with any such shareholder.

insolvency matters

Foreign private equity investors, particularly those interested in opportunities in the distressed M&A market, should also be familiar with Canada's insolvency laws.

- Receivership. Creditors can initiate a receivership either privately or by court appointment. A private receivership is initiated when a secured party exercises a contractual right to appoint a receiver pursuant to a security agreement. Private receivership is usually the quickest and least expensive alternative for secured creditors. If there is opposition from a debtor or there are other factors requiring intervention by a court, a secured creditor may apply for a court-appointed receiver. In either a private or a court appointment, the receiver can be authorized to operate the business of a debtor where it is necessary or advisable.
- Bankruptcy and Insolvency Act ("BIA"). Under the BIA, creditors may commence bankruptcy proceedings by filing a petition against the debtor corporation. The debtor must owe the petitioning creditor at least $1,000 on an unsecured basis and the debtor must have committed an act of bankruptcy (e.g., failing to meet its liabilities as they become due) in the six months preceding the date of the petition. If the debtor does not oppose the petition, the creditor may obtain a bankruptcy receiving order ten days after the debtor is served with the petition. Once a receiving order is made against it, the debtor's assets will vest in the trustee in bankruptcy, subject to the rights of secured creditors.

  The BIA allows a debtor to make a proposal to all of its unsecured creditors, which may, at the debtor's option, include secured creditors. To be accepted, each class of creditors must vote to accept the proposal by a majority in number and two-thirds in value. A proposal that is opposed by secured creditors will not be binding on the secured creditors.
- Companies' Creditors Arrangement Act ("CCAA"). The CCAA allows an insolvent corporation with claims against it exceeding $5 million to make a compromise or arrangement with some or all of its secured and unsecured creditors while continuing to operate its business. The plan of compromise or arrangement must be approved by a majority in number and two-thirds in value of each class of creditors voting. Once approved by the creditors, the court must sanction the plan. Once sanctioned, the plan is binding on all the creditors included in the plan.

The proposal procedure under the BIA and proceedings initiated under the CCAA are primarily debtor-driven and are somewhat analogous to proceedings under Chapter 11 of the *United States Bankruptcy Code*. Generally, the proposal procedures under the BIA are less costly and take less time to complete than proceedings under the CCAA. However, the rules and timelines for BIA proposals are more rigid and the courts have less discretion than under the CCAA which has very few procedural requirements.

a cautionary note

The foregoing provides a summary of aspects of Canadian law that may interest investors considering doing business in Canada. A group of McMillan lawyers prepared this information, which is accurate at the time of writing. Readers are cautioned against making decisions based on this material alone. Rather, any proposal to do business in Canada should most definitely be discussed with qualified professional advisers.

(The information in this brochure is current to October 2012)