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Contributing Editors:
Dr. Markus P. Bolsinger & Christopher Field
Dechert LLP

glg Global Legal Group

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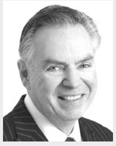
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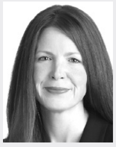
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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

The year 2023 saw a global slowdown in the private equity market as investors continued to grapple with rising interest rates, inflationary pressures and other economic uncertainties. Despite that, the Canadian private equity market remained relatively active in 2023. According to the year-end market overview report by the Canadian Venture Capital and Private Equity Association, $9.7 billion of private equity was invested across 625 deals in 2023. Middle-market deals continued to be a significant driver in terms of total value invested. In the face of rising interest rates, national security concerns and economic uncertainty, private equity investors have focused more on small- and medium-sized businesses, with deals under $25 million comprising 85% of the deals that were closed in 2023. The information and communications technology sector continued to capture the largest share of activity measured by both the number of deals and total value, surpassing 2022 investment levels. Other noteworthy sectors included industrial and manufacturing, cleantech and business products and services.

1.2 What are the most significant factors currently encouraging or inhibiting private equity transactions in your jurisdiction?

Private equity firms continue to have record levels of dry powder on hand and pressure to invest those funds; however, acquisition financing, while still readily available from third-party lenders, became increasingly expensive as interest rates increased in 2023, causing some private equity firms to look to alternative lenders to provide their financing.

While continuing economic uncertainty, rising inflation, supply chain instability and geopolitical tension impacted private equity markets globally, including the number and cadence of Canadian deals, the Canadian market managed to demonstrate some stability with ongoing private equity activity across all sectors and industries, driven by continuing access to financing, the availability of ample dry powder on the buy-side and attractive multiples on the sell-side.

From the private equity buyer's perspective, seller's valuation expectations remain high. Valuation multiples in Canada have remained high compared to long-term averages. According to Crosbie & Co., companies with an enterprise value of $100–$250 million traded at an average of 9.8×, a premium of 64% to small companies with an enterprise value of $10–$25 million, which traded at an average of 6.0×.

The lower Canadian dollar combined with relatively smaller deal size continues to make Canadian targets attractive to foreign private equity buyers, especially if the targets establish (or have the potential to) a presence in the U.S. and are therefore able to generate revenue in U.S. dollars.

1.3 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Family offices and institutional investors, such as pension funds, are continuing to be active and independent participants. When these investors compete against traditional private equity firms in an auction setting, they tend to offer private-equity-like transaction terms, including the use of representations and warranties insurance. If it is not a competitive process, then their approach and timelines are often more closely aligned to that of a strategic purchaser. Since these investors generally have the ability to hold an investment indefinitely, they are generally more willing to acquire businesses that include real estate assets and manufacturing operations that may have "legacy issues".

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Privately held Canadian businesses are generally acquired by private equity buyers either through a purchase of assets or a purchase of shares. Private equity investors will typically incorporate a Canadian acquisition corporation and fund it by way of interest-bearing debt and equity on a 1.5:1 basis in order to comply with Canadian thin-capitalisation rules. This acquisition entity then acquires all of the shares/assets of the Canadian target and, in the case of a share acquisition, the acquisition corporation and target are then "amalgamated" under the relevant corporate statute to align the leverage with the operating company. Often, these buyout structures include key management rolling their interest and maintaining their equity stake. The then amalgamated operating company will then typically make add-on transactions by way of direct acquisition whereby the operating company will acquire the share or assets of an add-on target directly. Add-on acquisitions continue to account for over 70% of private equity buyouts in Canada and 60% of 2023 deal value, which is an accurate representation of the trend over the last five years. With that said, while buyouts remain the preferred form of investment, minority investments, once only common in smaller growth equity deals, are a continuing and increasingly popular trend, accounting for 32% of private equity dollars invested in 2023.

2.2 What are the main drivers for these acquisition structures?

Whether a Canadian acquisition should be completed by purchasing assets or shares is driven by tax and non-tax considerations. The weight given to these factors will depend on the circumstances of the transaction and the parties' ability to leverage their respective positions. From the point of view of a potential purchaser, the greatest benefits of an asset sale are tax advantages and the ability to pick and choose the assets and liabilities that will be acquired. The majority of "legacy liabilities" can be left with the seller. However, asset sales tend to be significantly more complex in larger transactions and can require more third-party consents for material contracts. Furthermore, certain permits and licences may not be transferable or assignable in an asset sale. In contrast, a share sale is relatively simple from a conveyancing perspective and less likely to trigger third-party consent requirements or a need to apply for new licences or permits by the purchaser. From the seller's perspective, tax considerations generally favour share transactions, as individual sellers may be able to utilise their $1,016,836 (as of 2024) lifetime personal capital gains exemptions to shelter a portion of the proceeds. Changes to Canadian tax rules in 2021 have seen "hybrid" transaction structures, which were previously popular for providing tax advantages to both buyer and seller and involved selling shares and assets as part of the same transaction, to be largely ineffective.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Sellers of businesses, including key management, will often roll over equity into a corporate purchaser. The precise terms of the equity interests offered to, or required of, continuing management are often a major point of negotiation in transactions. Typical structures include multiple classes of equity with one class designed to pay out investors, such as the fund and any co-investors (including management), in priority over a second class designed to pay out continuing management only if the business is eventually sold for more than a certain threshold value (incentive equity). Stock options (more tax-effective) or phantom stock options (less tax-effective) are also commonly granted.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Minority positions require private equity firms to consider different structuring issues due to the lack of control. The minority rights stipulated in the shareholders' agreement become a primary concern to ensure private equity firms have veto power (or at least significant influence) over critical decisions. Likewise, put and drag-along provisions are key to ensure the private equity investor has flexibility with regard to their exit strategy. A minority interest is often taken by a private equity investor in the form of convertible preferred shares or a convertible debt instrument.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Allocation to management will vary on a deal-by-deal basis but typically ranges from 10–20%. Aligning the equity interests granted to continuing managers with the continued growth and success of the company is essential. In order to align interests, most stock option plans call for options to vest and become exercisable upon the achievement of certain conditions. Those conditions are typically tied to either continued employment and the passage of time, and/or certain performance/success requirements, such as the achievement of stated financial returns. Generally, management equity is structured to allow for repurchase by the company upon a termination of employment. Options granted to management may vary on whether they are exercisable following termination of employment based on whether the termination was a "good exit" or a "bad exit" or on where the management ultimately lands following the exit. The options granted to management typically vest automatically in the event of a sale of the company by the private equity investor.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Under Canadian law, the threshold for firing an employee "for cause" is very high and hard to establish. For that reason, circumstances amounting to an exiting management equity holder leaving as a "bad leaver" are not tied to a causal dismissal but rather to more general negotiated grounds of dismissal. Any circumstance where an exiting equity holder is terminated or is acting in competition with the business will typically be treated as a "bad leaver". Good leavers are usually those leaving due to death, disability or retirement.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Private equity firms utilise their equity positions, or negotiated minority rights, to assign seats on the board of directors to their principals and nominees. As such, they typically have the authority to run the portfolio company for the period of their investment. In Canada, the names and addresses of private companies' board of directors are publicly available information. In response to foreign pressures to bring disclosure of ownership of Canadian corporations in line with other major countries, the federal government introduced legislative amendments to improve beneficial ownership transparency by creating a national public and searchable beneficial ownership registry for federally incorporated businesses. As of January 22, 2024, all private federal business corporations are required to report beneficial ownership information to Corporations Canada annually and within 15 days of any change to the information contained in their corporate records pertaining to beneficial ownership. In Quebec, Bill-78, which came into force on March 31, 2023, made beneficial ownership information with respect to owners of Quebec corporations publicly available. Similarly, Ontario, British Columbia, Manitoba, Saskatchewan, Nova Scotia, and Prince Edward Island have also introduced comparable amendments to their corporate legislation, requiring companies to privately report or maintain records of their beneficial ownership structures. While this information for corporations formed under certain jurisdictions will not be public (under currently enacted legislation), it is indicative of a growing trend towards greater transparency.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

The default dissent rights provided under corporate legislations are typically supplemented through unanimous shareholder agreements ("USAs") that ensure the private equity investor has ultimate control over the portfolio company. In applicable Canadian jurisdictions, USAs are equivalent to the articles of a corporation. Often, such veto rights cease to apply where a private equity investor's equity interest is reduced below a given benchmark. Where a private equity investor holds a minority position, veto rights are still typically enjoyed over critical business matters such as acquisitions, changes to the board and management team, the issuance of new equity or debt and the disposition of key assets.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

In order for a shareholder agreement to be automatically enforceable against a subsequent shareholder, which shareholder agreement sets forth veto arrangements, fetters the discretion of the directors or supplants the default provisions of corporate legislation where permitted, it must be unanimous in nature (so-called USAs as described above). At the director level, only certain powers of directors can be fettered by a unanimous shareholders' agreement and, most notably, the fiduciary duty owed by the director of a portfolio company to the company itself cannot be restrained. To the extent shareholders assume the rights and powers of directors under a USA, they also assume the related liabilities.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

In contrast to some American jurisdictions, controlling shareholders in Canada do not owe a fiduciary duty to minority shareholders.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

A shareholder agreement that is not signed by all of the shareholders of a company is treated as a regular commercial contract and, as such, not automatically enforceable against a subsequent shareholder; it is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute. In contrast, a USA is a creature of statute, provided that it is signed by all shareholders. Corporate legislation expressly recognises the ability of shareholders to contract out of certain statutory requirements and fetter certain powers of directors. To the extent a USA restricts the powers of directors to manage the business and affairs of the corporation, shareholders who are given that power inherit the rights, powers, duties and liabilities of a director under corporate statutes or otherwise. Canadian courts will generally not enforce restrictive covenants that unnecessarily restrict an individual's freedom to earn a livelihood. What is reasonably necessary depends on the nature of the business, its geographic reach, and the individual's former role in that business. Canadian courts will not enforce a restrictive covenant that does not contain any time limit.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Depending on the jurisdiction of incorporation, the board of directors of a Canadian corporation may be subject to certain minimum residency requirements. Notably, boards of directors for companies incorporated under the federal statute must consist of at least 25% resident Canadian directors or include at least one resident of Canada if the board has fewer than four members. Residency requirements only remain under the federal statute and the corporate statute of Manitoba. Corporations formed under the corporate statutes of the other provinces, including Ontario, British Columbia and Alberta, do not have Canadian residency requirements, thus making those jurisdictions more attractive to foreign-owned private equity firms who want to have the boards of their Canadian portfolio investments aligned in terms of membership with those of their investments held outside of Canada.

In Canada, all directors owe fiduciary duties to the corporation, including a duty to act in the best interest of the corporation. The potential statutory liabilities directors are exposed to can be extensive and the basis for this potential liability varies. Directors may be personally liable for their own wrongdoing or failure, such as breaching the duties of loyalty and of care, or, in other instances, held personally liable for wrongdoing by the corporation. The statutes that impose liability on directors include those governing: corporate matters; securities compliance; employment and labour protection; taxation; pensions; bankruptcy and insolvency; and environmental. In Quebec, Bill-96 also introduces potential liability for directors in the case of non-compliance with French language legislation by a corporation.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors of a corporation who are nominees of a particular shareholder are subject to fiduciary duties to act in the best interest of the corporation, not the shareholder who nominated them. Canadian corporate statutes require directors to disclose in writing the nature and extent of their interest in a proposed material contract or transaction with the corporation. This provision applies whether the director is a party to the contract or transaction personally or is a director or officer of, or has a material interest in, a party to the contract or transaction. As such, all conflicts or potential conflicts the director has, as a result of their relationship with the nominating party and/or other portfolio companies, must be disclosed. In situations of conflict, the statutes require the director to refrain from voting on any resolution to approve the contract or transaction except in narrow circumstances. Notably, Alberta's corporate statute contemplates a corporation's ability to include a "corporate opportunity waiver" in its articles or in a unanimous shareholder agreement. Alberta is the first to introduce this waiver, which is beneficial to directors, officers and shareholders of a corporation wishing to take advantage of certain business opportunities. This is particularly attractive to private equity investors who may wish to take advantage of business opportunities afforded to them by being engaged with several different boards and management teams operating in the same industry.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust, foreign direct investment and other regulatory approval requirements, disclosure obligations and financing issues?

Aside from the typical due diligence process, the timetable for transactions is often governed by the regulatory approval required under the Competition Act and the Investment Canada Act, where applicable. In Canada, certain large transactions trigger advance notice requirements under the Competition Act. Such transactions cannot be completed until the end of a review 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. Amendments to the Competition Act have resulted in more transactions being subject to pre-merger notification as all corporate and non-corporate entities under common direct or indirect control are now treated as "affiliates" and are thus included in the threshold analysis. This will be especially impactful on traditional private equity funds that are structured as limited partnerships. In addition to competition regulations, under the Investment Canada Act, foreign investments that exceed prescribed values or that relate to a cultural business or involve national security issues are subject to Investment Canada Act approval. This allows the federal government to screen proposed investments to determine whether they will be of "net benefit" to Canada. Under the Investment Canada Act, non-Canadian investors are also permitted to submit a voluntary notification of such investments, and such voluntary filings are also subject to a national security review.

4.2 Have there been any discernible trends in transaction terms over recent years (i.e. trends in terms of regulatory approval)?

The increase in foreign investment, typically from the U.S., has influenced transaction terms, which have gradually shifted to become increasingly similar to those in the American market. For example, the size of indemnity caps, while still significantly higher in Canada than in the U.S., continues to trend downwards. Earn-out provisions have also become increasingly popular as a way to bridge the valuation gap, with an increase in the median length of earn-out periods, which was 24 months in 2023. The use of representations and warranties insurance is increasingly being seen as standard in the Canadian private equity market and impacts what terms are "market" in deals using that product. The increased regulation of foreign investment in Canada through the application of the constantly evolving merger review regimes set forth in the Competition Act (Canada) and Investment Canada Act, including the ability of a transaction to be challenged by the Canadian government on the grounds of national security interests, has resulted in significantly more resistance to Buyers willingness to accept "hell or high water" antitrust risk in a transaction, including the increase in public company style "no indemnity" deals.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Canadian takeover bids require that adequate arrangements (an interpreted statement) must be made, with the effect that a bid cannot be conditional on financing. Typically, an interested investor will have entered into a binding commitment letter with a financial institution or other provider of funds before making a takeover bid. On the other hand, statutory plans of arrangement can be conditional in nature and allow more flexibility to provide collateral benefits to managements, etc. Due to this flexibility, most uncontested Canadian privatisation transactions involving private equity investors are completed by a plan of arrangement.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

In friendly acquisitions, provisions relating to the fiduciary duties of the public target's board and break fees are often seen in connection with "no-shop" provisions. The "no-shop clause" is typically subject to a fiduciary out, upon which the break fee becomes payable. The break fee, traditionally in the range of 2–4% of the transaction's value, is now typically based on enterprise value.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Private equity buyers typically require purchase price adjustments to reflect the financial condition of the target. Generally, these are based on a net working capital adjustment. Earn-out provisions are also often contemplated by private equity buyers in order to link the seller's ultimate consideration to the financial success of the target entity post-closing. Similar to the trend seen in other markets, earn-out provisions became especially popular during the COVID-19 pandemic in Canada as a way for transaction parties to account for uncertain future performance without discounting a company's purchase price. While still relatively rare, the use of "locked box" structures is growing in Canada as a means to limit post-closing price adjustments. Private equity firms generally arrange their own credit facility and invest on a cash-free, debt-free basis. On the sell-side, private equity investors typically prefer simple consideration structures with less variability and that minimise the size and scope of post-closing obligations.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Private equity sellers and management teams will try to minimise the representations and warranties, and insist on a short survival period for representations given. Private equity sellers will further try to limit their exposure by ensuring they do not include a full disclosure, 10b-5 type representation by liberally using materiality qualifiers and by including an anti-sandbagging provision (although most agreements typically do not have an anti-sandbagging provision). Private sellers are also increasingly insisting on public-company style "no-indemnity" exits. This is in part due to the growing familiarity with and acceptance of representations and warranties insurance in the Canadian market.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Private equity sellers generally insist on limiting post-closing exposure as much as possible. As referenced above, they typically limit the length and scope of indemnity provisions as much as possible, as well as other post-closing covenants and undertakings. Public-style exits, in which a private seller's post-closing exposure is limited exclusively to instances of fraud, are becoming increasingly common.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Representations and warranties insurance use is not universal, but, as noted above, has become commonplace and is now widely used in Canadian private equity transactions. Policy limits typically cap out at 10–20% of the purchase price of a transaction. Available coverage has become broader and is now available for both fundamental and non-fundamental representations and warranties. Over recent years, the number of typical carve-outs and exclusions from such policies has decreased quite significantly. However, they often remain for pre-closing taxes, pension funding, the potential recharacterisation of consultants as employees, certain environmental matters and other high-risk deal specific terms. In addition, certain exclusions can arise out of deal-specific matters that present themselves during the due diligence review process. Apart from a short "blip" at the end of 2021, where demand exceeded the ability of the insurers to keep up with demand and premiums increased, generally, policy premiums for representations and warranties insurance have declined in recent years and may now range between 2.5–4% of the policy limit. The retention amounts required under these policies have similarly declined. It is now common to see this figure ranging between 0.5–1% of enterprise value.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

It is advisable for private equity investors to build restrictions on the scope of representations and warranties that fund investors are required to give on a sale transaction. Representations and covenants as to the portfolio company's operations are more properly given by management shareholders who will have in-depth knowledge in this regard. Private equity investors required to indemnify a purchaser in respect of a breach should do so on a several basis and limitations should be placed on the dollar amount for which private equity investors are responsible. Typically, post-closing indemnification on the sale lasts 12–18 months (with fundamental representations and warranties lasting longer) and negotiated indemnity cap (for non-fundamental representations) often in the range of 5–30% of the sale price. Involvement of foreign participants, especially U.S.-based participants, is often correlated to the lower end of these ranges applying, whereas we see the upper ends of the ranges more commonly on truly domestic Canadian transactions.

6.6 Do (i) private equity sellers provide security (e.g., escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

While representations and warranties insurance is becoming more popular, the traditional approach of a seller indemnity coupled with a purchase price holdback or escrow is also still common for both private equity buyers and sellers in Canada. In the event of an earn-out provision, set-off rights against the earn-out payment are also typical.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buyer (e.g., equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity transactions typically involve equity financing from the private equity investor and debt financing from a third-party lender. Comfort, with respect to the equity financing, is often provided in the acquisition agreement, which generally contains a commitment for the private equity investor to fund and complete the acquisition upon the satisfaction of certain conditions. The acquisition agreement generally contains a representation and warranty that the private equity investor has sufficient funds to provide the funding. A separate equity commitment letter is often provided by the private equity firm. Comfort letters from the third-party lender are typically tabled to provide comfort with respect to the debt financing. In instances where a financing condition is in place, some transactions contemplate a reverse break fee that sellers are entitled to if the transaction does not close as a result of the financing condition not being met.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are becoming more common in Canadian private equity transactions. These fees are typically negotiated as a fixed dollar amount or a percentage of enterprise value. Due to the increased exposure of the target entity to potential damage from a failed deal, reverse break fees are often higher than the negotiated break fee on a transaction, ranging up to 10% of enterprise value.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

While traditionally seen as the gold-standard, ideal exit for a private equity seller, initial public offering ("IPO") exits are not common in Canada and are the exception rather than the typical exit scenario. According to the Canadian Venture Capital and Private Equity Association, while the Canadian market saw 68 exits in 2023 with a total value of $581 million, only one private equity-backed IPO was reported. The most common exit is the sale to another private equity fund. When considering an IPO exit, private equity sellers should be aware of the costs of preparing for and marketing the IPO, which includes the preparation of a prospectus and a road show. It is also important for the private equity seller to be aware that an IPO will not allow for an immediate exit of its entire position and that the private equity's final exit will be subject to lock-up provisions, which will limit the investor's abilities to sell their shares for a period of time following the IPO.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Underwriters in an IPO will require these shareholders to enter into a lock-up agreement as a condition to the underwriting to ensure their shares do not enter the public market too soon after the IPO. While the terms of lock-up agreements are subject to negotiation, they typically last 180 days.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track processes have not typically been popular in Canada. However, given the state of the market before the pandemic and the increased use of these processes in the U.S., we expect to see them becoming more common in Canada as buyers continue to seek ways to hedge the risk of a failed attempt to go public while at the same time increasing valuations.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (including the syndicated loan market, private credit market and the high-yield bond market).

Foreign investors, largely U.S.-based, account for a substantial portion of private equity investment in Canada. U.S. investors often bring their American debt financing with them or obtain Canadian debt financing. Private equity investors utilising U.S. debt sources for Canadian private equity transactions need to develop FX hedging strategies, which are typically only provided by traditional banks and can be costly. Traditional senior secured debt obtained from a domestic Canadian bank, often in the form of a revolving credit facility or term loan, remains the most common source of debt financing in Canadian private equity transactions. At times, senior secured debt is also supplemented by mezzanine financing (usually by way of subordinated debt) through banks or other financial institutions. The private credit market can serve to fill the gap in providing funding to Canadian small- and middle-sized businesses who may prefer the flexibility of an alternative lender, such as flexibility in repayment schedules and structure. Since 2021, the private credit market has extended over $17 billion to Canadian deals.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no relevant legal requirements or restrictions that affect the choice of structure used for debt financing in Canadian private equity transactions. Canadian loans tend to be fully secured against all available collateral.

8.3 What recent trends have there been in the debt-financing market in your jurisdiction?

Most private equity firms typically use private lending as part of the financing for their Canadian transactions. According to Crosbie & Co., the average equity portion of the capital structure consisted of 53% in 2023.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The use of continuation funds in the Canadian private equity market is increasing. Historically, continuation funds were typically used as investment vehicles by sponsors that needed additional time to manage a portfolio company before their exit. However, continuation funds have since become more popular with sponsors as an alternative exit strategy that offers investors the option to either sell their interest in the portfolio company or remain invested by rolling into the continuation fund and becoming a limited partner.

9.2 Are there any particular legal requirements or restrictions impacting their use?

The Institutional Limited Partners Association (the "ILPA") provided guidance on May 15, 2023 relating to continuation funds. Pursuant to the guidance document, the ILPA recommends certain parameters to align interests between the general partner and limited partners. The recommendations were developed through two operative guiding principles: (i) continuation funds should maximise value for existing limited partners; and (ii) limited partners that roll into the continuation fund should be no worse off than had the transaction not taken place. While the ILPA sets out recommendations that are not legally required, the guidance looks to protect the interests of limited partners in private funds.

10 Tax Matters

10.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Many of the common tax considerations in transactions with private equity funds apply equally to transactions with strategic buyers. However, there are several considerations that may take on added importance when transacting with foreign private equity investors. Dividend payments made by Canadian portfolio companies to foreign private equity investors are generally subject to a 25% withholding tax, although this rate may be substantially reduced if the dividend recipient is resident in a jurisdiction with which Canada has a tax treaty. Non-resident investors should also familiarise themselves with Canada's thin-cap rules that prohibit Canadian companies from deducting interest on a portion of interest-bearing loans from specified non-residents that exceed one-and-a-half times the tax equity of the "specified non-residents" in the Canadian company and can also trigger deemed dividends in certain circumstances that effect withholding tax. Historically, intermediary entities in tax-favourable jurisdictions such as Luxembourg and the Netherlands were often utilised by foreign-based private equity funds investing into Canada. However, the Organisation for Economic Cooperation and Development's Base Erosion and Profit Shifting ("BEPS") initiative, including the Multilateral Instrument to which Canada is a party (the "MLI"), has significantly affected the usage of such intermediaries.

10.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Stock options remain the most popular equity-based compensation tool, due to their favourable treatment (no taxation until exercise and general eligibility for a capital-gains equivalent rate of tax). Other popular equity-based compensation arrangements for management include stock appreciation rights and deferred stock units.

10.3 What are the key tax considerations for management teams that are selling and/or rolling over part of their investment into a new acquisition structure?

Investors in a Canadian company are generally permitted a tax-free rollover when exchanging their shares in the company for shares of another Canadian company, but not when such shares are exchanged for shares of a non-Canadian company. An effective workaround may be available in the latter circumstances through the use of "exchangeable shares" (i.e., shares of a Canadian company that are exchangeable for, and are economically equivalent in all material respects to, shares in the relevant foreign company).

10.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

On June 22, 2023, new mandatory tax disclosure rules in the Income Tax Act (Canada) (the "ITA") came into force, which expanded the scope of transactions that taxpayers, advisors and investors must report to the Canada Revenue Agency (the "CRA"). The mandatory disclosure rules encompass three types of transactions: reportable transactions; notifiable transactions; and transactions including uncertain tax treatments. The new rules are intended to help provide the CRA with better access to information and impose substantial penalties for non-compliance.

Separately, the 2024 federal budget announced the proposed increase to the portion of capital gains earned by a taxpayer that must be included in taxable income from one-half (50%) to two-thirds (66.67%) for capital gains realised by corporations and trusts on or after June 25, 2024.

In addition, as noted above, the Organisation for Economic Cooperation and Development's BEPS initiative and the MLI have significantly decreased the interposition of intermediary entities in favourable jurisdictions (such as Luxembourg and the Netherlands) by foreign private equity funds for their Canadian investments.

Amendments to the Excise Tax Act (Canada) impose goods and services tax obligations on "investment limited partnerships". If the partnership meets the definition of "investment limited partnership", the general partner will be obligated to charge and remit goods and services tax on the fair market value of any management/administrative services provided.

Recent amendments to the ITA have restricted the stock option deduction that may be claimed by employees in certain circumstances. For stock options granted after June 30, 2021, there is a $200,000 annual limit on the eligibility of employees of certain businesses to claim a 50% tax deduction for those stock option grants. This could affect the compensation packages required to retain and incentivise management.

11 Legal and Regulatory Matters

11.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

Amendments to the Competition Act (Canada), most of which came into force on June 23, 2022 as part of the Budget Implementation Act, 2022, allow orders that companies ordered to produce information must provide information in the possession of their affiliates, and orders that require persons outside of Canada to provide information. Given the 2021 amendments to the Competition Act to include non-corporate entities as affiliates, funds structured as partnerships are now considered affiliates of both portfolio companies under their control and any other similarly structured sister funds controlled by the same entity. This increases the number of entities that may be subject to the orders made to companies to produce information in the possession of their affiliates.

Changes to the national security review regime under the Investment Canada Act came into effect on August 2, 2022 to permit non-Canadian investors to submit a voluntary notification of such investments that are not subject to a mandatory filing. The Canadian government may initiate a national security review within 45 days of receiving a voluntary filing.

11.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g., on national security grounds)?

Private equity investors are not subject to specific regulatory scrutiny; however, the amendments to the Competition Act noted above are likely to increase the number of private equity transactions that trigger advance notice requirements under the Competition Act. Additionally, the Competition Bureau's practice is to consider all portfolio companies where a private equity company has a significant interest when considering the implications of a new merger. In other words, the Bureau will not limit its substantive review to the particular fund or portfolio company that is involved in the merger.

Additionally, foreign investments that constitute an acquisition of "control" of a Canadian business require approval under the Investment Canada Act to confirm that the investments are of "net benefit to Canada" when such investments exceed particular monetary thresholds, which depend on the country of origin of the ultimate controller of the investor, whether the target company is a "cultural" business and whether the transaction is a direct or indirect investment in the Canadian business. Separately, any investment into a Canadian business may be reviewed under the Investment Canada Act on national security grounds.

Net benefit reviews are subject to approval by the Minister of Innovation, Science and Industry (for non-cultural reviews) or the Minister of Canadian Heritage (for cultural reviews). Further, as noted above, amendments to the national security review regime under the Investment Canada Act create a process by which non-Canadian investors are permitted to submit a voluntary notification for a minority acquisition of a Canadian business and the acquisition or establishment of a business with only limited Canadian aspects (i.e., some Canadian employees or Canadian assets). While these acquisitions are not subject to a mandatory filing, the Canadian government may initiate a national security review within 45 days of receiving a voluntary notice of such investment from the non-Canadian investors.

Transactions involving the acquisition of control of a Canadian "cultural" businesses to non-Canadian-controlled investors are subject to more rigid scrutiny, requiring net benefit reviews at relatively low financial thresholds. A "cultural" business is one that publishes, distributes or sells books, magazines, periodicals or newspapers, produces, distributes, sells or exhibits films, video recordings or music, or is a radio, television, cable or satellite broadcaster or a broadcast network. Businesses that do not fall strictly within these categories but have activities analogous to them, such as video games, may also be captured by the government's interpretation of the "cultural" business definition. Additionally, and separate from "net benefit" reviews, based on recent policy statements from the Department of Innovation, Science, and Economic Development Canada, Canadian businesses, including many cultural businesses, which are engaged in the interactive digital media sector, may face scrutiny under potential national security reviews. In particular, the Canadian government is concerned about the risk of hostile foreign actors using such businesses to spread disinformation or manipulate information. Interactive digital media businesses include video games, virtual reality, social media and other technology platforms that can be used for entertainment, education, training, and e-commerce.

Amendments to the Investment Canada Act that have received royal assent but are not likely to come into force until at least 2025 will require pre-closing filings for control acquisitions and certain types of minority investments into Canadian businesses engaged in activities raising national security concerns. Although the identities of those business activities are not yet established, they will likely capture Canadian businesses involved in the defence industry, critical minerals, critical infrastructure, critical goods and services, and sensitive technology such as artificial intelligence, among others. It is possible that certain interactive digital media companies could also be caught. For foreign investments into Canada that will require such pre-closing filings, investors will have to wait until the government has had the chance to review their investments to determine whether national security reviews are warranted. The precise length of time for this pre-closing waiting period has not yet been announced.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments are not subject to additional legal or regulatory requirements.

11.4 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g., typical timeframes, materiality, scope, etc.)?

The majority of private equity investors conduct fairly comprehensive legal due diligence, reviewing all material legal documents, including the target entity's corporate records, materials contracts and employment records for any "red flags". In addition, publicly available searches are also typically conducted in order to identify any registered encumbrances, active legislation, bankruptcy filings and other similar matters. Most legal due diligence is conducted by external counsel and other professionals, such as environmental consultants. The length of the diligence review and materiality threshold applied differs greatly and is often dependent on the nature of the sale process, the risk tolerance of the private equity investor and the industry the target is in.

11.5 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g., diligence, contractual protection, etc.)?

Canada's Corruption of Foreign Public Officials Act ("CFPOA") was enacted in 1998 to ensure commercial fair dealing, government integrity and accountability, and the efficient and equitable distribution of limited economic resources. CFPOA prohibits the promise, payment, or giving of money or anything of value to any foreign official for the purpose of obtaining or retaining business or gaining an improper advantage and concealing bribery in an entity's books and records. Private equity transactions, especially in sensitive industries or which involve a target with material government contracts, typically specify diligence contracts as well as corporate records and policies for compliance with this legislation. In addition, representations and warranties are often obtained from the seller confirming the entity's compliance with the same. While the Foreign Corrupt Practices Act ("FCPA") is an American law, U.S. private equity investors often seek assurances that Canadian target entities are complying with FCPA. If the Canadian target is not currently owned by an American interest, this can be problematic.

11.6 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Typically, Canadian courts are hesitant to pierce the corporate veil and hold shareholders liable for their portfolio companies. However, Canadian courts will pierce the corporate veil where a corporate entity is controlled and used for fraudulent or improper conduct. Likewise, to the extent a shareholder usurps the discretion of a director to manage the business, that shareholder will expose itself to the liabilities of a director of the entity, including where a USA or unanimous shareholders declaration is used to remove the powers of the directors and instil such powers in a shareholder.

12 Other Useful Facts

12.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Other factors that commonly raise concerns for private equity investors, especially foreign investors, include: that foreign ownership in specified industries such as financial services, railway, airline, broadcasting and telecommunications is limited by certain federal statutes; management and administration fees paid by a Canadian resident to a non-arm's-length non-resident are subject to a 25% withholding tax; and that Canadian employment laws differ fairly significantly from American laws and impose more obligations and potential liabilities on a target corporation. Due to the Russian invasion of Ukraine, Canada has also introduced an increasing number of constraints on trade and financial dealings with Russia. These restrictions have introduced new considerations for Canadian private equity investors and can constrain the opportunity of certain private equity funds to invest if Russian investors are present in the funds. In the province of Quebec specifically, Bill-96 may raise further considerations in terms of investment in entities with operations in Quebec, giving more onerous obligations for entities operating in Quebec to comply with French language requirements. Further, many Canadian businesses do business with Cuba and Canada maintains blocking legislation that prevents the extraterritorial application of U.S. sanctions on Cuba (creating a conflict with U.S. law). Lastly, amendments to the Competition Act (Canada), came into effect on June 23, 2023, to criminalise wage-fixing and no-poaching agreements between unaffiliated employers. These amendments prohibit agreements between employers: (i) to fix, maintain, decrease or control salaries, wages or terms and conditions of employment; or (ii) to solicit or hire each other's employees. Non-solicitation provisions are common in the context of M&A transactions. While the Competition Bureau released guidelines providing that the Bureau will "generally" not assess clauses that are ancillary to merger transactions and joint ventures, consideration should be given to ensuring certain types of M&A agreements (i.e., NDAs and exclusivity agreements) do not pose legal risks in light of these amendments.

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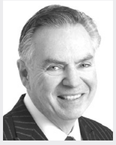
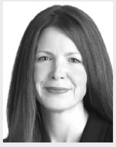


Michael P. Whitcombe has been recognised as one of Canada's leading business lawyers in *Lexpert's Guide to the Leading 500 Lawyers* in Canada. Michael is Co-Chair of McMillan's Private Equity Group. He principally practises in the areas of negotiated merger and acquisition transactions (domestic and cross-border), private equity investments, strategic alliances, complex commercial arrangements and corporate governance. Michael regularly advises private equity firms along with other medium and large corporations (both domestic and international) and their boards of directors in connection with their operations throughout Canada. He has significant industry experience in the private equity, pharmaceutical, automotive, manufacturing, distribution, service, entertainment, hospitality and tourism sectors.

McMillan LLP
181 Bay Street, Suite 4400
Toronto, Ontario, M5J 2T3
Canada

Tel: +1 416 865 7126
Email: michael.whitcombe@mcmillan.ca
LinkedIn: www.linkedin.com/in/michael-whitcombe-17529ba



Brett Stewart is recognised in the *IFLR1000 Financial and Corporate Guide 2016* and *2018* as a rising star in the areas of Investment Funds and Banking, ranked in *Lexpert's Guide to the Leading U.S./Canada Cross-Border Corporate Lawyers in Canada 2015* as a Corporate Lawyer to Watch in the area of Corporate Commercial Law, and was selected as a *Lexpert®* Rising Star: Leading Lawyer Under 40 for 2014 by *Lexpert® Magazine*. Brett is Co-Chair of McMillan's Private Equity Group. With a focus on assisting domestic and foreign clients with negotiated transactions including M&A, private equity financings, venture capital financings and management buyouts, Brett has represented clients in a number of sectors including agri-food, food manufacturing, aerospace and defence, engineering, pharmaceuticals, tech and clean-tech, manufacturing and transportation.

McMillan LLP
181 Bay Street, Suite 4400
Toronto, Ontario, M5J 2T3
Canada

Tel: +1 416 865 7115
Email: brett.stewart@mcmillan.ca
LinkedIn: www.linkedin.com/in/brett-stewart-05a5109

Enda Wong is an experienced business lawyer whose practice focuses on M&A, and private equity and venture capital investments. She has recognised expertise in acquisition financing and corporate organisations and structuring. Practising both common law and civil law, and called to the Bar in Ontario and Quebec, Enda works on a variety of regional, national and cross-border transactions. She is trusted for advice on the similarities and differences between the two legal systems. Enda has gained significant experience and industry knowledge in the technology and food and beverages sectors. Acting on behalf of private enterprises, institutional and private equity investors and non-profit organisations, Enda provides counsel on commercial, regulatory and compliance-related issues.

McMillan LLP
1000 Sherbrooke Street West, Suite 2700
Montréal, Quebec, H3A 3G4
Canada

Tel: +1 514 987 5034
Email: enda.wong@mcmillan.ca
LinkedIn: www.linkedin.com/in/enda-wong-81011430

Bruce Chapple is a business lawyer with a dynamic practice focused on M&A, private equity and complex commercial transactions. He draws on extensive industry-specific knowledge in sectors ranging from manufacturing to asset management. With a broad scope of experience, Bruce advises on acquisitions and divestitures in the Canadian market, as well as Canadian issues associated with international transactions. He also provides counsel on joint ventures and limited partnerships. His clients include public and private corporations, subsidiaries of international corporations, private equity funds and investment vehicles, including for real estate transactions. Bruce is known for delivering practical solutions and getting deals done.

McMillan LLP
181 Bay Street, Suite 4400
Toronto, Ontario, M5J 2T3
Canada

Tel: +1 416 865 7024
Email: bruce.chapple@mcmillan.ca
LinkedIn: www.linkedin.com/in/bruce-chapple-897b82

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