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Unit 1: Roles, Legal Forms and Transaction Types

OVERVIEW OF M&A TRANSACTIONS

- **Merger:** consolidation of two corporations
  - Two entities merge to form a new entity
  - This is largely a US term, in Canada we usually say "amalgamation"

- **Acquisition:** one corporation acquires control of another
  - The target company still exists as an independent legal entity
  - Legal entities remain the same, but one owns the other

Reasons to Merge or Acquire

- Increasing capabilities (e.g. expand R&D opportunities, vertical or horizontal integration, etc.)
  - Horizontal: buying same industry
  - Vertical: move through the chain of value (e.g. manufacturer of iron buys distributor, then buys a company that uses iron
- Competitive advantages/larger market share/synergies
- Diversifying or consolidating products and services
  - Can reduce risk or dependency on a limited product line (e.g. oil and gas company sells items ancillary to their production to survive)
  - Dispositions – can reduce diversification as well to focus on the most profitable lines of business – more strategic
- Replacing leadership
- Access to capital (financial, human, etc.)
- Cutting costs/survival
  - E.g. stop losses through divesting

ROLES IN TRANSACTIONS

1. **Accountant:** (1) provide tax advice; (2) financial statements/financial review
   a. Involved early on
   b. Can be internal (treasurer, CFO, etc.) or external (accounting firm)
   c. Looks at financial position of entity being acquired and financial effects of acquisition
   d. Helps with tax structuring

2. **Broker/Investment Banker:** (1) brings buyers and sellers together; (2) valuations; (3) funding' (4) industry knowledge
   a. Not involved in every deal – usually in larger deals (e.g. deals using an auction process)
      i. Strategic purchases – typically don't need a broker
      ii. Private equity – large fund (equity fund) buying a company and don't know operations of the company = use a broker
   b. An intervening party that assists with raising capital (to buy the company) and bringing the transaction together

3. **Lawyer:** (1) structure; (2) negotiating/drafting/opinions; (3) coordinating; (4) working with others
   a. Negotiating – advocate for client to preserve the deal. Trying to keep everything in a framework of progression, so more collaborative, less adversarial than a litigator
      i. Not win/lose because not always buying 100% of the other company – sometimes buying, e.g. 80% of the company so need to continue working with the other company after the deal
   b. Coordinating – need to talk to tax lawyer, employment lawyer, real estate lawyers, IP, etc., - lawyers as the "quarterback" of the transaction

4. **Others:** engineers, environmental specialists – depends on what the industry in question is
   a. Engineers – for technical info (quality, necessity, etc.) about what you're really buying
   b. Environmental specialists – for info about the land (if contaminated, if it needs work, etc.)
      i. Environmental specialists are becoming increasingly important – operations that aren't environmentally friendly have huge reclamation costs – as upfront diligence people are making sure these issues don't exist or if they do, to have the fixed prior to the purchase

DEFINITIONS & CONCEPTS

Revenue	• Proceeds from the sale of goods and services, gains from the sale or exchange of assets, interest and dividends and other realized increases in equity
Expenses	• Costs identifiable with operations of a period or with revenues earned during a period • What it costs you to *earn* revenue
Net Income	• Essentially "profit" (net income = revenues – expenses) • "Losses" occur when such expenses exceed revenues
Assets	• Things of value owned (assets = liability + equity) • Any proper – money and monetary equivalents (e.g. inventories, equipment, land, etc.)
Liability	• Debts – amounts to be paid in the future or obligations to deliver goods or services
Equity	• Residual interest of an owner or shareholder (equity = assets – liabilities) *E.g.* SaratCo put in $50 through loan and $50 through purchasing shares. Assume no income • Balance sheet: assets = $100 cash; liability = $50; equity = $50 *E.g.* SaratCo: revenue = $100; expenses = $60; cash = $100; liability = $50 • Income statement: net income (revenue – expenses) = $40 • Balance sheet: assets = $140; liability = $50; equity = $90
Shares	• Sections 26(3) and (5) of the ABCA – shares must have the following 3 rights: (1) right to vote (2) right to receive dividends (3) right to participate in liquidation (receive equity when company is wound up) • If there are multiple classes of shares, all shares in the aggregate must have the attributes, but some classes can have some attributes while other classes have other attributes • Right to vote: you can have shares with a right to vote, but there are certain matters in which you can still vote whether you have a voting or non-voting class of shares (only specified circumstances – rare) • Every share in a class must have the same rights as other shares in the class
Stated Capital	• Aggregate consideration received by a corporation on its issued share capital • E.g. how much money the company received where it has issued shares of others, the amount of money that's been put into the company by virtue of issuing shares (so whatever you paid for your shares is the stated capital) • Section 28 of the ABCA – required to maintain it • Why do we track this? (1) to show ownership/equity (2) relevant to other calculations (3) tax purposes – how much you can get out tax free
Dividends	• Amounts declared by the directors for distribution to shareholders in proportion to their holdings, having regard for the respective rights of various shares • Section 43 of the ABCA – solvency requirements (a) after payment, unable to pay its liabilities as they become due (liquidity test) or (b) realizable value of the assets would be less than the aggregate liabilities and stated capital of all classes (solvency test: assets < liabilities & stated capital) • **A company can't declare a dividend unless it meets s. 43 so that you do not defeat creditors or parties that have lent money into the company** – prevents companies from giving dividends and escaping liability, since the lender can only sue the company and not the individual who is given the dividend • Section 26(3) and (5) of the ABCA – shares to have a right to receive dividends and, if more than one class of shares, rights of the shares of any class are equal in all respects
Capital Property	• Property for investment or to earn income (e.g. land, equipment, etc.) • Usually that which generates income – e.g. apple farm, apples are not capital property, the trees are. E.g. land, buildings, equipment used in a business, securities such as stocks, bonds, etc. • Does not include the trading of assets of a business, such as inventory • Assume shares of a company are capital property for this course

Adjusted cost base	• Amount to acquire the capital property • E.g. price of shares, cost of partnership unit, etc.
Capital Gains/Losses	• Results from the disposition of capital property • Capital gain/loss = proceeds of disposition – adjusted cost base – selling expenses • Lifetime capital gains exemption is $835 000 **[check this]**
Taxable Income	• Income, less applicable tax deductions, to which the tax rate is applied *E.g.* Income of $100. Assuming 50% tax rate, pay $50 of tax and left with $50
Taxable Capital Gain	• 50% of the capital gain to which the tax rate is applied • Essentially taxed at half the rate of ordinary income – government policy is to give good tax cuts for capital property to encourage investment *E.g.* Capital gain of $100. Only 50% is taxed at the 50% rate. Pay $25 tax and left with $75
Tax of Dividends	• Dividends, to which the tax rate is applied (certain inter-corporate dividends can be made tax-tree – typical rates are 31% - 41%) *E.g.* Dividend income of $100. 31%-41% tax rate, left with $69-$59

Two types of purchases:

1. **Strategic:** another player in the industry buys out another in the same business
2. **Equity:** someone with a lot of money (like a mutual fund) buys out a company they do not know the business of

Note: securities legislation applies to: (1) issuing shares (2) purchase and sale of securities (3) takeovers

CANADIAN LEGAL FORMS

1. **Limited Liability Corporations**
    a. **Characteristics:**
        i. Separate legal entity (***Salomon***): has the same rights, powers and privileges of a natural person
        ii. Can contract, sue and be sued in its own name
        iii. Incorporated: federally (*CBCA*) or provincially (*ABCA*)
        iv. Separate taxpayer
    b. **Advantages:**
        i. Limited liability of shareholders
            1. SH is not responsible for a corporation's torts, breach of contract, etc. SH liability is limited to their investment in the corp (all they can lose is what they put in). BUT if a SH provides a personal guarantee, they may be liable for more than the value of their shares
            2. Directors don't necessarily have limited liability – they have fiduciary duty (can be liable for wrongs committed)
        ii. Easier to acquire capital
            1. Because of limited liability, so less risky investment for shareholders to invest in
        iii. Perpetual existence (until positive action taken to bring the company to an end)
            1. Existence is independent of whether shares change hands/SH dies
            2. Can be dissolved by filing of proper forms
        iv. Relatively easy to create
        v. Inter-corporation dividends *generally* flow tax-free between connected Canadian corporations
        vi. Tax-deferred rollover possible (defers when you have to pay tax)
            1. Section 85 rollover – if you have a business, you can sell capital to the business in exchange for shares (avoid paying for capital gains)
    c. **Disadvantages:**
        i. Less flexible: subject to a lot of legislation/regulation
        ii. CDN residency requirements for directors in certain jurisdictions – was 25% but is now removed
        iii. Start-up costs and high filing fees

2. **Unlimited Liability Corporation (ULC) – very rare**
    a. **Characteristics:**
        i. Separate legal entity – has the same rights, powers and privileges of a natural person
        ii. Can contract, sue and be sued in its own name
        iii. Formation: in AB, BC & NS
        iv. Separate taxpayer
    b. **Advantages:**
        i. Perpetual existence
        ii. Relatively easy to create
        iii. Inter-corporate dividends generally flow tax free between Canadian corps
        iv. Tax-deferred rollovers possible
        v. **Certain flow-through treatments may be available**
    c. **Disadvantages:**
        i. **Unlimited liability for current and former SHs (can be liable for up to 2 years from when you were a SH)**
        ii. Start up and filing costs can be high because you have to get tax advice
    d. **When are they used?**
        i. Generally used for tax purposes – commonly used by US corps as a Canadian subsidiary or to hold Canadian assets, as it offers tax advantages for US SHs
        ii. Personal liability can be mitigated using shell co's or holding co's with minimal or no assets (blocker co's)

3. **General Partnership**
    a. **Characteristics:**
        i. Persons carrying on business in common with a view to profit. Don't need a written agreement or filing of forms
        ii. NOT a separate legal entity
        iii. Partner = an *agent* of the partnership and the other partners
        iv. Not a separate taxpayer – partnership calculates taxes as a separate entity and allocates it among partners, but must file an information tax return
    b. **Advantages:**
        i. Simple to form and dissolve
        ii. Partnership agreements allow partners to define their contractual rights
        iii. Subject to less regulation than corporations
        iv. Allows the pooling of funds among partners
        v. Partners taxed directly on the profits or losses of the partnership (losses can help offset gains from other sources of income)
    c. **Disadvantages:**
        i. Partners have unlimited liability for all partnership debts (joint & several liability) if there was express, implied or apparent authority
        ii. Each partner is an agent of the other partners
        iii. Subject to an agreement otherwise, partnership terminates on the death or bankruptcy and certain other events
        iv. Tax-deferred rollover only if all partners are Canadian residents

4. **Limited Partnership**
    a. **Characteristics:**
        i. NOT a separate legal entity – formed under statute
        ii. At least 1 GP and limited partners
        iii. GP has unlimited liability (is often a corp)
        iv. LPs liability is limited to their investment BUT on the condition that they can't take part in the "control of the business" – if they do, they lose their limited liability status)
        v. Not a separate taxpayer
    b. **Advantages:**
        i. Liability of each limited partner is limited (so long as they don't lose their status)
        ii. Subject to less regulation than corporations
        iii. Partners taxed directly on the profit or loss of the partnership (losses can help offset gains from other sources of income)
    c. **Disadvantages:**
        i. General partner has unlimited liability for all partnership debts
        ii. Limiting partners can lose status if they are part of the "control of the business"

iii. Partners must decide which discretionary deductions (e.g. CCA) for tax purposes (calculated at the partnership level)
iv. Potential restrictive "at-risk" rules that limit deduction of losses up to the "at-risk" amount
v. No tax-deferred rollover unless all partners are Canadian residents

5. **Joint Ventures**
   a. **Characteristics:**
      i. More of a business arrangement than a business vehicle
      ii. NOT a separate legal entity or partnership
         1. Essentially a contract between two or more corporations to contribute assets, operations, or services
      iii. Venturers still hold title to relevant assets
      iv. Terms of the JV are governed by contract, including how earnings are split
   b. **Advantages:**
      i. Flexibility in formation and operation
      ii. Income or loss calculated at the venturers' level – doesn't file separate tax return
   c. **Disadvantages:**
      i. Uncertain legal status – may be re-characterized as a general partnership
         1. Need to be careful that the JV is clearly stated to be that and not a partnership – would mean unlimited liability and different tax treatment
      ii. All issues must be addressed in contractual documentation

6. **Sole Proprietorship**
   a. **Characteristics:**
      i. Not a separate legal entity (same as the individual)
      ii. Individual holds title to relevant assets
      iii. Income is your personal income – taxed at personal tax rate
   b. **Advantages:**
      i. Flexibility in operation
      ii. Inexpensive to form
      iii. Income or loss calculated at individual's level – "proprietorship" doesn't file separate tax return
   c. **Disadvantages:**
      i. Individual has unlimited liability for all proprietorship debts – highest level of risk you can have
      ii. Difficult to attract financing – often limited to the credit of the individual
      iii. No perpetual existence

TYPES OF M&A TRANSACTIONS

Main questions: how do we structure the transaction? Need to consider:

- Who are the parties to the agreement?
- Tax implications
- Scope of the agreement – how broadly drafted, how broad the obligations
- Due diligence
- Impact on employees – does the buyer need employees to run the business?
- Strategic vs financial purchase:
  - Strategic: same industry, competitors, acquisition happening
  - Financial: e.g. private equity firm, bring the money but usually not there to run the business

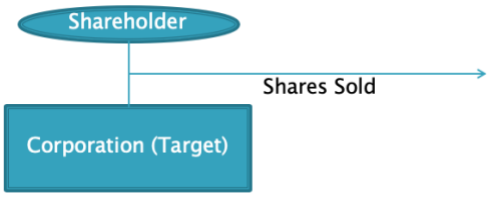
Asset Purchase and Sale



- **General:** purchaser acquires the **assets** it wants and leaves behind the liabilities (other than those attached to purchased assets)
  - Liabilities attached to purchased assets will remain attached (e.g. security interest registered under the PPSA)
- **Seller of the ASSETS is the target corporation,** NOT the shareholders
  - The agreement is between the "seller" (TargetCo) and the "purchaser" – that is the only contractual relationship
- **Relationships:** contracts associated with certain assets may need to be **novated or assigned** (which will require *third party consent*) because they often contain clauses requiring consent to asset sales
- **Concerns/due diligence:** more limited scope (only to the assets and liabilities being acquired/assumed)

- **Employees:** all employees are deemed to be terminated on the closing date (but if they are terminated and don't have proper notice, there may be a severance issue)
- **May need shareholder approval**
    - If the seller is a general partnership, then need agreement of partners. If the seller is a corporation, s 190 ABCA applies
    - **Sec 190 ABCA:** in a sale of all or substantially all of the assets, must get shareholder approval by special resolution
        - Each share carries the right to vote whether or not it otherwise carries the right to vote
        - Special resolution: resolution passed by a **majority of not less than 2/3 of the votes** cast by shareholders who voted
        - "All or substantially all": fundamentals of business have changed (e.g. Westjet sells planes – is now a bus company)
    - **Sec 191 ABCA:** dissenting shareholder rights apply
        - Dissenting shareholders can bring an order in court requiring the corporation to pay out FMV of their shares as determined by the court (can be very expensive for the corporation)
- **Note:** asset sale is generally more attractive for **purchasers**
    - Purchaser can pick and choose what assets it wants and does not obtain liabilities other than those attached to purchased assets
    - Purchaser can often start to deduct Capital Cost Allowance on purchased capital assets right away

Share Purchase and Sale



- **General:** target is sold inclusive of all its assets and liabilities, known and unknown
    - You're buying the *corporation* because you're buying shares
    - As the buyer, you just step in and start running it how it was before
    - Has a separate legal personality – so all contracts will accompany the deal
- **Seller is the shareholder(s)**, not the target corporation. Target corporation does not need to be a party to the agreement
- **Relationships**: should not change *unless* the contract contains a change of ownership clause
    - Means nothing needs to be assigned or novated to the purchaser and no consent needed **unless there is a change of control clause** (a change of control in which 51% or more of the shares are purchased)
    - Not necessary to transfer title to assets and pay transfer and sales tax
- **Concerns/Due Diligence:** broad scope (acquiring all assets and liabilities), need to do DD at TargetCo level and SH level
- **Advantages of share purchase (for seller)**
    - **Tax:** generally more advantageous for sellers
        - *(1) Capital gains:*
            - Shares are capital property and therefore taxed as capital gains – taxed at ½ the rate of ordinary income
        - *(2) Exemption of up to $892, 218 (2021) of capital gains may be available:*
            - Lifetime capital gains exemption if requirements are met and hasn't yet been used
        - *(3) Reduces taxable gains through "safe income" dividends:*
            - E.g. dividend up cash to connected corporation tax-free
        - *(4) Reserves for any portion of the sale price not payable until later*
        - *(5) No sales (gst/pst) and excise taxes on share purchases*
            - In contrast to asset sales which may include these
    - **Assets:** not necessary to transfer title to assets and pay transfer and sales taxes
    - **Legal:** purchaser acquires all of the benefits and rights of the TargetCo (non-assignable contracts, permits and licenses without having to obtain the consent of third parties if there are no change of control provisions)
    - **Employees:** purchaser acquires all employees needed to operate the business (continuation of employment)
- **Disadvantages of share purchase (for purchaser)**
    - **Tax:** less advantageous for purchaser
        - As a purchaser you want to know the tax position – when determining tax you're looking for the difference in value from when it was bought to when it is sold
        - In buying shares there isn't a lot of choice because the shares have a value – vs when buying assets, every asset has a different tax treatment so there is more flexibility
        - Purchaser prefers to allocate the purchase price in the following order (to get tax benefits – note this is for an asset purchase)
            - Inventory (full deductibility)
            - Depreciable capital property with a high rate of capital cost allowance (i.e. "tax depreciation")

        - Eligible capital property (the tax pool for goodwill)
        - Depreciable capital property with a low rate of capital cost allowance, and
        - Non-depreciable capital property (e.g. land)
    - Tax-related drawbacks:
        - *(1) a "change of control" triggers year-end*
            - Share sale where there is a change of control (51% or more of shares sold) triggers a deemed "year-end" which may require filing two tax returns in the tax year if the deal doesn't close by the end of the year
        - *(2) restrictions on the use of capital and non-capital losses after a change of control*
            - In an asset purchase there are potential future and immediate tax benefits of later selling assets such as inventory, in contrast to shares which are generally held onto for longer
- **Assets:** purchaser can't "cherry pick" assets or employees
    - Share sale includes everything – for better or for worse
- **Liabilities:** purchaser acquires all of the liabilities and historical baggage (undisclosed liabilities)
- **Employees:** unless terminated, the purchaser takes all of the employees, including any it doesn't want

Why did hybrid transactions emerge?

- From a tax perspective, the vendor wants to sell the shares and the buyer wants to buy the assets
- Real incentive on the seller to sell shares of the company because of the capital gains exemption/capital property
- **Hybrid summary:** company is purchaser
    - (1) Purchaser acquires shares from the seller – seller might sell exactly the number of shares to get the capital gain exemption
    - (2) Purchaser buys shares from the shareholder, but they want assets
    - (3) The seller will rebuy those shares from the purchaser but they don't pay the purchaser with cash, they pay with the assets of the company

Hybrid Purchases/Sale Transactions

- Sale of some shares and all of intended "target" assets
- **Benefit:** provides the seller with certain tax advantages (capital gains election) and the purchaser with advantages of an asset purchase
- **Goal:** benefit both parties – purchaser acquires assets but not shares while seller gets to use its capital gains exemption
- **<u>Two hybrid schemes:</u>**
    - **Sample A** – 3 steps:
        - **(1)** Purchaser acquires enough shares from the seller (allowing the seller to use its capital gains exemption)
        - **(2) Shares purchased by the purchaser are repurchased by the target** (consideration consists of some of the "assets" of that TargetCo – aka share redemption)
        - **(3)** Remaining "assets" of the target are purchased
        - **Result:** purchaser ends up with assets, while the seller gets to use its capital gains exemption
    - **Sample B** – more complicated but more widely used – 7 steps:
        - **(1)** Purchaser sets up a new corporation (NewCo)
        - **(2)** Seller (TargetCo; TC) exchanges common shares into preferred shares (with FMV equaling capital gains exemption if they are buying enough assets)
            - For our purposes, preferred shares have a fixed value
        - **(3)** Seller transfers preferred shares to NewCo in exchange for a promissory note
            - Amount of the note equals the value of the preferred shares
        - **(4)** Purchaser funds NewCo, gives them cash. They use this cash to buy assets from the seller
            - So NewCo has the assets they wanted and the preferred shares in TargetCo
            - TargetCo has cash and the note from NewCo
        - **(5)** TargetCo buys back preferred shares from NewCo using the cash they received for assets
            - NewCo now has assets and cash
            - TargetCo now has their preferred shares back and promissory note
        - **(6)** Redemption proceeds paid to NewCo
            - Purchase price equivalent to the sale of assets in step 4
        - **Result:** NewCo acquires assets of TargetCo. TargetCo gets to use its capital gains exemption because they have sold a promissory note for cash, which is a capital gain
- B is more widely used because (1) segregates the risk factor, and (2) it is redeeming shares for dollar value instead of asset value, so harder for the CRA to come and make sure you've got it right on asset value (3) more authoritative, CRA has already taken something like this to tax court before

What if the purchaser does not have the resources to fund the purchase price in full?

1. Bank financing/leverage financing
2. Vendor take back: pay part now and pay the rest later
3. Earn out: a way to bridge a gap between what people think the price should be
    - E.g. pay $500 000 now, but if the company earns more than $200 000 of revenue then the seller will get a piece of that
4. Estate freeze: a way to freeze up the value of the company using preferred shares to lock in value
5. Gradual sales through share purchase plans: plans where people can buy shares
    - E.g. employee stock option plans

Succession (Estate Freeze)

- **Estate freeze – general**
    - **Succession:** how one corporation passes from one generation to another; how the company survives
    - **Estate freeze:** an asset management strategy where an estate owner seeks to transfer assets to his or her beneficiaries without tax consequences
        - Exchange common shares for fixed redeemable/retractable preferred shares
        - *Crystalize* the value
        - New common shares issued at nominal output
    - Purpose: freeze the value of the target corporation (TC)
        - (1) Transfer the future growth in the value of the corporation to a purchaser/successor/employee **while existing owners retain the corporation's current value**
            - **New entrant doesn't obtain a transfer of the existing value** of the corporation, but *only obtains the accrued value created subsequent* to the freeze
            - Current owners are effectively divested of future growth as a freeze limits the value of the current owner's estate to the value at the date the freeze is implemented
        - (2) **Capital gains and other tax exposure on the future growth that would otherwise arise when assets are transferred out of the hands of the current owners are avoided**
    - Uses:
        - (1) Pass future value growth of capital assets onto the **next generation** of a family, thereby minimizing the income tax which will arise on the deemed FMV disposition, which will occur on the death of the parents
        - (2) Can be used to ease **key employees** into partial ownership of a business, to promote loyalty and dedication, and possible succession to more full ownership in the future
        - (3) Purchaser might **not have the resources** to fund the purchase price in full
    - Estate freeze may be full or partial
        - **Full freeze:** current owners fully divest themselves of any participating growth shares moving forward
        - **Partial freeze:** current owners re-subscribe for a portion of the new common shares (issued at nominal value)

- **Estate freeze types**
    - **<u>(1) Internal freeze</u>:** *the shares of an existing corporation are reorganized into a freeze configuration, allows new SHs to come in and buy new shares inexpensively*
        - Common shareholders of TargetCo exchange their shares for redeemable (at the option of shareholders) or retractable (at the option of corporation) preferred shares having a **fixed or "frozen" value** equal to FMV of the common shares that they exchanged (company's whole value as of now)
            - Present value of the corporation is now transferred into the frozen preferred shares since the preferred shares are not redeemable or retractable
            - At any time, the value of the PS could be transferred out of the company and into the hands of the preferred shareholders if the shares are redeemed or retracted (so the company has "no value" left)
        - New common shares are issued to the purchaser/successor for nominal value
            - No taxable benefit is conferred on the purchaser/successor since there **has not been a transfer of existing value**
        - Holders of the frozen PS still have an interest in keeping the company profitable
            - **They depend on the viability of the company to get cash for their frozen shares at the time of redemption or retraction**
        - Purpose: eliminates the value of the company – allows new shareholders to come in and buy new shares cheaply
        - **Summary:** exchange common shares for fixed redeemable preferred shares in which the SH can redeem at any time. Effect is to crystallize the value of shares to FMV of the corp at the time the shares were issued.

This locks in the value of the company for the preferred SH. New common shares issued at nominal amount

- **(2) Freeze of assets:** *e.g. if you have a sole proprietorship, want to bring friends into the company but the friends don't want to pay or don't have the money*
  - Incorporate a company (that will have no value)
  - Can buy new shares in the new company for nominal amount
  - Each shareholder can own, e.g. $100 shares in NewCo
  - Then transfer the assets from the sole proprietorship into NewCo, so it is now worth the price of NewCo, then take back the preferred shares
  - No taxes here – all friends own shares and you own all the preferred shares (so no one has a bump economically)
  - If any new growth in the company happens, the new money is divided up and preferred shares can be paid out
  - **Summary:** freeze value of assets by transferring them to NewCo in exchange for preferred shares of NewCo equal to FMV of the assets. Issue common shares of NewCo to successors. Transfers future growth in the value of the assets, as the successors have shares in NewCo (no value but has assets) and get any growth in the company

- **(3) Holding corporation freeze:** *if you own shares in a company, want to bring in shareholders and they come into a new company (can also be used to creditor proof)*
  - Create new holding corporation (HoldCo)
  - HoldCo issues new common shares to entrant (beneficiary of the freeze)
  - The TC's (OpCo) common shares are transferred to HoldCo in return for freeze shares with equivalent value. Put the money out of reach of unsecured creditors
  - OpCo shareholders transfer OpCo common shares to HoldCo. In return, they take freeze shares in HoldCo, having a fixed value equal to the FMV of the transferred OpCo shares
    - Original shareholders now own freeze preferred shares in HoldCo
    - HoldCo owns shares in OpCo
    - Entrant participates in new growth in entire corporate structure by holding common growth shares in HoldCo
      - Money in OpCo can now be generally distributed tax-free to HoldCo via inter-company dividend
      - If capital is needed in OpCo, HoldCo can lend money distributed up via dividend back down to OpCo
  - Creditor proofing OpCo: HoldCo makes a loan with security agreement. HoldCo is now a secured creditor of OpCo and will rank ahead of unsecured creditors who sue OpCo
  - **Summary:** Make new company so shareholders can pay nominal amounts for shares (no value). Before the transaction you own 100% of the shares of the operating company. Then we transfer the shares of the operating company to the new company, which is now a holding company (only holds the shares) and take back the shares of the holding company. So now we have an operating company wholly owned and preferred shares

- **Gradual Sales: Employee Share Ownership Plans**
  - Can reward/incentivize employees without having to pay out cash
    - Bringing employees into the company by giving them some ownership
    - Note: if setting these up for a client be careful about the rights you attach to the shares, particularly voting rights
  - **(1) Stock option plan:** *right to purchase shares/vesting*
    - Option to purchase a specific number of shares at a fixed price (exercise option) upon vesting - the right to acquire shares at a certain time in the future, at a certain price and perhaps, even, if certain circumstances occur
    - Can be on a schedule as to when they can be purchased to incentivize employee to work for a longer period with the company (vesting period)
    - Common in public companies
    - **Benefits of issuing (actual) shares:** transition the company, motivate employees, don't have to spend any money
    - **Disadvantages of issuing shares:** dilute control of the company, don't want terminated employees to have shares/options (but can mitigate by issuing restricted shares or specify in SH agreement that company can buy back shares on termination)

- **(2) Cash settlement plan:** *cash settlement (no shares)*
  - Same idea as with actual stock options, but option holder can choose between (1) buying the actual shares or (2) electing to get the cash value
    - Cash value = market value of shares – exercise price of shares
    - If option holder elects to take cash, there is no dilution as with traditional stock options, but it does not act to transition ownership of the company
  - **Benefits:** no dilution of ownership, motivate employees
  - **Disadvantages:** not actually transitioning company, must have enough cash to pay out
- **(3) Phantom share plans:** *receive notional shares*
  - "Redeemable" notional/phantom shares awarded via a contractual agreement
    - The value of the shares at the start date is "pegged", but the shares aren't actually issued
      - The value is generally whatever the current FMV is upon contracting
    - Can attribute whatever rights to the phantom shares, such as the right to get a dividend
  - When the holder of the phantom shares wishes to "redeem" the shares, they can "sell" them back to the company and the company will pay out the *difference* between the current FMV and the price originally ascribed
    - Cash value = market value of shares – pegged value of shares
  - **No transfer of ownership**
- **(4) Restricted share plan:** *shares with restrictions*
  - Shares that are issued with certain restrictions on them that are triggered by specified events
    - E.g. hold the shares as long as you work for the company (allows company to sever all relationships with unwanted employees)
  - A mechanism that is designed to avoid future conflicts – gets people out of the company if certain things happen where you would want them out
  - Can increase the value of the corporation this way, BUT does not give holders an entitlement to ownership (economic value only)
- **(5) Full share ownership plan:** *receive shares*
  - Receive ordinary shares either outright, or by loaning person money to buy shares
    - Usually done by smaller companies, easier to do
  - A company that's running short on cash may try to pay for things with shares

Amalgamations

- Two or more corporations merge and carry on as one
  - Amalco is a continuation of all the predecessor companies, but carries on as a new company
  - Largely statutory in nature
  - NOTE: <u>can't amalgamate partnerships, only corporations</u>
- **Amalgamation happens by operation of LAW rather than by sale (disposition) = no tax consequences**
  - Because no transfer occurred, there is no tax consequence, but the amalgamated corporation gets the *benefits and burdens of all the predecessor companies* (resulting entity is the sum total of all assets and liabilities amalgamated to make it)
    - I.e. the amalgamated corp is liable for the obligations of each amalgamating corp – different name and business number, but strictly speaking it is a continuance of the two corps)
  - However, amalgamation **<u>triggers a tax year end</u>** – must file a tax return for all the predecessor companies the day before amalgamation (consider Jan 1 as a desirable date to amalgamate on)
- **Can only do an amalgamation between two corporations in the <u>same jurisdiction</u>**
  - E.g. if two corporations, one in AB and the other in ON, you have to move the AB company to ON and then merge the two ON companies (called "continuing")
- Two ways to amalgamate under the ABCA:
  - **(1) Long form amalgamation**
    - Use when there are different groups at play – i.e. applies where third parties are involved (outside the existing corporate structure)
    - Amalgamating corporation signs an **amalgamation agreement** and submits it for **<u>approval by shareholders</u>** (*<u>need shareholder approval!</u>*)

    - *(1) Amalgamation agreement sets out* (**ABCA s 182**):
      - **182(1)(a)**: provisions included in the articles of incorporation
      - **182(1)(b)**: the name and address of each proposed director of the amalgamating corporation
      - **182(1)(c)**: how shares of each corp are to be converted into shares of the amalgamating corp

- **182(1)(d)**: if any shares of an amalgamating corp are not to be converted into securities of the amalgamated corp, the amount of money/securities that the holders of the shares are to receive in addition to or instead of the securities of the amalgamated corporation
    - If any shares are not converted, those shareholders must be paid out
- **182(1)(e)**: can't issue the fractional shares – must pay them out
- **182(1)(f)**: whether the bylaws are those of the amalgamating corp and if not, a copy of the proposed bylaws
- **182(1)(g)**: whether amalgamation is contingent on future events occurring
    - I.e. anything special or unique about the deal that you need (e.g. person X must stay for 1 year)
- Cancellation of shares held by one amalgamated corporation in another
    - I.e. if someone owns shares in both they cancel out because it is now one company

▪ *(2) Shareholder approval of amalgamation agreement* (**ABCA s 183**)
- **183(1)**: directors **of each corporation** must send amalgamation agreement for approval to SHs
- **183(2)**: there must be a SH meeting and dissenting SHs are entitled to be **paid out FMV** in accordance with s 191 ABCA
    - Issue: must have enough cash to pay out, especially if there are a lot of dissenting shareholders
    - Pro: can effectively use an amalgamation to *kick people out* this way
    - Issue: FMV is determined by the court – uncertainty here
- **183(3)**: **each share carries the right to vote** here – special section of the ABCA
- **183(4)**: holders of shares of a class are entitled to vote separately as a class if amalgamation agreement allows
    - If one class or series votes the amalgamation down, it will fail
- **183(5)**: amalgamation agreement is adopted when the SHs have approved it by **special resolution**
    - Special resolution = 2/3rds approval (vote)
- **183(6)**: any time *before the issue of a certificate of amalgamation* the agreement may be terminated by the directors of an amalco, notwithstanding approval of the agreement by SHs or all or any amalgamating corps
    - This is an "out" provision – allows you to stop
    - Note: **can't backdate an amalgamation** – it happens when the articles are filed and the certificate issued

○ **(2) Short form amalgamation**
▪ Done where there is common ownership between the shareholders – doesn't matter how many corps you stack on as long as the shareholders are the same
▪ Only applies to **wholly owned subsidiaries** of holding corporations
▪ *Only need director resolution approval* – **NO shareholder approval required OR amalgamation agreement** required for short-form amalgamation (because all shareholders are the same)

▪ **(A) Vertical Short-Form**
- Amalgamation of holding corps and one or more wholly owned subsidiaries (**ABCA s 184(1)**)
- **184(1)(a)**: approved by a **resolution of the directors of each corporation**, and
- **184(1)(b)**: the resolutions provide that:
    - (i) The shares of each amalgamating subsidiary shall be cancelled (no payment)
        - Only the parent company shares survive
    - (ii) Articles of amalgamation will be the same as the articles of incorporation of the amalgamating holding corporation,
    - (iii) No securities shall be issued by the amalgamated corporation in connection with the amalgamation, and
    - (iv) The stated capital of the amalgamated corporation shall be the same as the stated capital of the amalgamated holding corporation(s)
- Notes:
    - Often done as some form of "clean up" – taking a lot of subs and putting them into the parent co
    - Articles of amalgamation are the same as articles of incorporation of the amalgamating holding corporation
    - Shares of each subsidiary are cancelled (no payment)

        - No securities are issued by the amalgamated corporation in connection with the amalgamation
        - Stated capital of amalgamated corporation is the *same* as the stated capital of amalgamating holding corp

- **(B) <u>Horizontal Short-Form</u>**
    - Two or more wholly owned subsidiaries of the same holding corporation (**ABCA s 184(2)**)
    - Same shareholders but might have companies that "sit beside each other" (same shareholders own two or more companies)
        - Shareholders are the same, no one being harmed, no change of economics to shareholders
    - **184(1)(a)**: approved by a **<u>resolution of the directors</u>** in each amalgamating corporation, and
    - **184(2)(b)**: the resolutions provide that:
        - (i) The shares of each amalgamating subsidiary shall be cancelled without any repayment of capital in respect of those shares
        - (ii) Except as may be prescribed, the articles of amalgamation will be the same as the articles of incorporation of the amalgamating subsidiary corp whose shares are not cancelled, and
        - (iii) The stated capital of the amalgamating subsidiary corp whose shares are cancelled shall be added to the stated capital of the amalgamating subsidiary corp whose shares are not cancelled
    - Notes:
        - Shares of all but one of the amalgamating subsidiary corp are cancelled (no payment)
        - Articles of amalgamation are the same as the articles of incorporation of the amalgamating subsidiary corp whose shares are not cancelled
        - Stated capital of the amalgamating subsidiary corp whose shares are cancelled are added to the stated capital of the amalgamating subsidiary corp whose shares are not cancelled

- **<u>AFTER the amalgamation agreement has been adopted or approved</u>** (for both long AND short form), then you must deliver **(1)** articles of amalgamation and **(2)** statutory declaration to the Registrar (***ABCA s 185(1)***)
    - **185(1)**: when amalgamating, need to deliver articles of amalgamation (not incorporation) – this is what creates the new company
        - Once the amalgamation agreement has been adopted under s 183 or approved under s 184, **articles** of amalgamation must be sent to the Registrar together with the documents required by ss 20 and 106
            - If the name of the amalco is not the same as that of one of the amalgamating corps, documents relating to the corporate names must be included
    - **185(2)**: every amalgamation has to have a **<u>statutory declaration</u>** – same liquidity and solvency test – to ensure they are not trying to evade a creditor or put the company in financial peril
        - Need to show reasonable grounds for believing that:
            - The amalco will be able to *pay its liabilities* as they become due,
            - The *realizable value of the amalco's assets will not be less than the aggregate of its liabilities and stated capital of all classes*
            - No creditor will be *prejudiced* by the amalgamation
            - Adequate *notice* has been given to all known creditors of the amalgamating corporations and no creditor objects to the amalgamation otherwise than on grounds that are frivolous or vexatious
    - **185(4)**: the amalco is in existence once the receipt of amalgamations and required documents are submitted to the registrar, and the registrar has issued a certificate of amalgamation
        - Once the articles are in, can't stop or reverse this process

> - **Must meet insolvency tests** (able to pay liabilities as they become due and assets will not be less than liabilities)
> - Must give notice to all creditors and give them a 30 day **notice period to object** (make sure you have sufficient time)
> - Amalgamation does not happen until registrar issues **certificate of amalgamation** – once this happens can't reverse it
> - Amalgamation agreement may be terminated at any time before the issue of a certificate of amalgamation by the directors of an amalgamating corporation, notwithstanding approval of the agreement by the shareholders

- **186**: when we're creating the amalco its new in that it has a new corporate existence, BUT all of the assets that were in all of the amalgamated companies at law become **assets of amalco**
    - This means that all of the **liabilities become liabilities of the amalco, including any legal claims**
    - Security they granted is now granted by amalco
    - Articles of the amalgamation are deemed to be the articles of incorporation of the amalco and the certificate of amalgamation is deemed to be the certificate of incorporation of the amalco
    - **Overall:** on that day *everything* transitions over – amalco is new but everything remains the same

Reverse Takeovers

- **When a private company wants to go public**
    - Advantages of going public:
        - Access to public stock exchange allows for quick capital raising or quick liquidity of otherwise illiquid private company shares
        - Also allows for easier debt financing
    - Disadvantages of going public:
        - Cost (through IPO)
        - Continuous disclosure requirements and regulations after going public
        - Now transparent to rivals
        - Must deal with shareholders
- **Process:** occurs when a **public** listed shell company acquires or merges with a private company, and the owners of the private company become the majority owners of the publicly listed company
    - The transaction structure between pubco and privateco may be any of the following: share exchange, amalgamation, or POA
- Example:
    - (1) A shell company is created (called pubco) and its shares are traded on the market
    - (2) In a share exchange, pubco acquires shares of privateco, and privateco's shareholders obtain shares of pubco
        - In a share exchange, each privateco shareholder must agree if you want 100% control
        - Share exchange ratio is such that former privateco shareholders obtain many more shares in pubco for each privateco share transferred to pubco – because privateco's shares are worth more (they are a legitimate business and not just a shell company)
    - (3) Result: pubco becomes the owner of privateco (so effectively privateco's operations become public)
        - And privateco's shareholders end up controlling pubco (become majority SHs)
- **Benefit:** become public without raising capital (simpler and faster than an IPO)
    - Avoid other regulations required of public companies through the stock exchange
    - No need for shareholder consent in terms of a shareholder resolution of the private company, as the shareholders of that private company need to agree to sell their shares. In short, the shareholder of the private company "consent" by entering into a share purchase agreement with the public company
- Stock exchange rules: generally require SH approval (information circular needed), material change reports
- Reverse takeover can also be done through a POA or an amalgamation
    - Avoids needing 100% of SHs of a private company to agree
    - 3 corner amalgamation (discussed in Unit IV)
- Note: don't assume that the private company is always weaker than the public company! This is why this is a *reverse* takeover

Plan of Arrangement

- **Court approved "arrangements" where the court essentially "blesses" a transaction (s 193 ABCA)**
    - Can be useful where it is difficult or undesirable to take all the necessary legal steps to get to a certain outcome
    - A POA is a multi-step transaction which may involve an amalgamation, an amendment to the corp's articles, a transfer of property, an exchange of securities, a compromise with creditors, or any combination of the above
- NOTE: if an arrangement can be effected under *any other provision in the ABCA,* an application cannot be made here unless it is **impracticable to effect the arrangement under that other provision**
    - Impracticable does not mean impossible, but simply difficult to put into practice
    - POAs are used only where there aren't any other provisions available in the ABCA or there are complex (multi-step) issues
- **Process:** POAs involve 2 court appearances and a shareholder meeting
    - **(1) Step 1: Negotiation of the definitive arrangement agreement with the target**
        - Offeror negotiates an "arrangement agreement" with the target, which defines the terms of the transaction

- Usually contains support provisions requiring the target to cooperate and support the offeror to complete the transaction
- Usually contains provisions restricting the target from considering other offers. If the target wants a "fiduciary out" clause to permit it to consider a superior proposal, then offeror should ask for a "break free and right to match" clause

- **(2) Step 2: First court appearance: parties request an interim order from the court**
  - Parties request an interim order which provides for:
    - (1) the calling of a special meeting of SHs and sets out procedural matters, such as the determination of the classes which have the right to vote separately and the percentage of approval required
    - (2) shareholders are granted a dissent and appraisal rights similar to what would have been received in an amalgamation
  - **Step 2A: target applies to court for an "interim order"** (give court a copy of arrangement agreement (**193(2)**)
    - The application materials include an affidavit from the target's senior management and a copy of the AA
    - The application is submitted shortly after the AA is announced
    - The application is made *ex parte* in that no notice of application is given to target's security holders
  - **Step 2B:** court will either dismiss the application or grant an **interim order, which directs the target to hold a meeting at which affected security holder will vote on an "arrangement resolution" approving the POA (193(2))**
    - Interim order describes:
      - The methods and timetable for calling and giving notice of the security holder's meeting;
      - The procedures to be followed at the meeting;
      - Who may attend the meeting;
      - Who may vote at the meeting;
      - The timeline for delivery of proxies;
      - The deadline for dissenting; and
      - The level of approval necessary (usually 2/3rds of securityholders who vote – but *could be more*)
    - SHs are granted a dissent and approval rights similar to what would have been received in an amalgamation
- **(3) Step 3: Giving notice of and holding the meeting**
  - Overall: rules about how to get the word out about the meeting, how to have the meeting
    - Could do a "fairness" option – have advisors value the arrangement
    - By doing this they can essentially show how the value of the company will increase/change
    - Essentially an independent valuation, helps to give an independent analysis and whether the arrangement makes sense from a voting perspective
  - **Step 3A:** target will mail an information circular to SHs, along with the arrangement agreement and the interim order, which describes and recommends the transaction (**193(5)**)
    - Includes what interest's management has in the deal and usually a fairness opinion from financial advisor
    - Must be a positive vote in support of the POA; ***if you fail on the vote the AA dies***
  - **Step 3B:** if the arrangement resolution is in writing and signed by all persons entitled to vote on it, the meeting does not need to be held and the resolution is valid (**193(7)**)
    - I.e. shareholder meeting is not need if it's a written resolution
- **(4) Step 4: Second court appearance: obtaining final approval from court**
  - Following a positive vote (after shareholder's meeting) the target will return to court for the approval order – where the court is asked to issue a final order approving the POA
    - The date of this court appearance is usually obtained with the interim order, and is usually scheduled within a few days after the security holder's meeting
    - Objecting SHs may attend and present evidence
  - **193(9)**: court can approve the arrangement as proposed, amend it, or reject it
    - In determining whether to grant the requested order, the court will consider whether the plan is "fair" to the SHs
      - Discretion to determine if POA is fair and reasonable even though it has been voted on
    - Fair and reasonable: (1) whether arrangement has a valid business purpose; (2) whether arrangement is fair and reasonable to the interests of affected parties (***BCE***) – large discretion of the court

        - Risk: that judges will materially amend the agreement (although this would be very rare) – but lately courts have expressed they are reluctant to be a "rubber stamp" – so need to make sure you've completed all the steps, why it's also important to do an independent valuation
    - **(5) Step 5: Closing the transaction**
        - The plan of arrangement becomes effective once the necessary documents (approval order) which include the final order are filed with the applicable corporate registry and (in some circumstances) a certificate is issued by the corporate registrar
        - The approval order is usually obtained on the same day as the hearing. The offeror and target may affect the transaction on the "effective date" of their choosing
        - **193(13)**: an arrangement as approved by the court is **binding** on the corp and all other persons
            - Cannot unwind this or consent out of the POA. Court sanctioned, so final

Plan of Arrangement – ABCA s 193

193(1): POA is a multi-step transaction which may involve (but is not restricted to):

- An amendment to the articles of a corp;
- An amalgamation of 2 or more corps;
- An amalgamation of a body corporate with a corporation that results in an amalco subject to this Act;
- A division of the business carried on by a corp;
- A transfer of all or substantially all of the property of a corp to another corp;
- An exchange of securities of a corp held by security holders that is not a takeover bid;
- A liquidation and dissolution of a corp;
- A compromise between a corp and its creditors or shareholders; or
- Any combination of the above

193(2): An application may be made to the court by a corp or a security holder or creditor of a corp for an order approving an arrangement in respect of the corp

193(3): If an arrangement can be effected under any other provision of this Act, an application may *not be made* under this section unless it is **impracticable to effect the arrangement under that other provision** (courts have interpreted this quite broadly)

193(4): In connection with an application, the court, unless it dismisses the application;

- Shall order the holding of a meeting of shareholders or a class or classes of shareholders to vote on the proposed arrangement
- Shall order a meeting of persons who are creditors or holders of debt obligations of the corp or of options or rights to acquire securities of the corp, or anyone else the court considers affected by the proposed arrangement
- May give any directions in the order respecting: (court can give more direction, what needs to be decided)
    - The calling of and giving of notice of the meeting
    - The conduct of the meeting
    - The majority required to pass a resolution at the meeting, and
    - Any other matter it thinks fit (this gives the court more power to be involved/make changes if it wants)
- May make an order appointing counsel to represent, at the expense of the corp, the interests of the SHs (can require a company to get legal representation for their shareholders if they aren't as sophisticated)

193(5): The notice of a meeting must contain or be accompanied with:

- A statement explaining the effect of the arrangement and
- If the application is made by the corp, a statement of any material interests of the directors of the corp and the effect of the arrangement on those interests
    - Basically have to give voting people the **full information** and it must be in a way they can **understand** (plain language)

193(6): An order made in respect of any meeting may not provide for any majority that is less than the following

- In the case of a vote of the shareholders, a majority of at least 2/3 cast by the SHs voting on the resolution
- In the case of a vote of creditors, a majority representing at least 2/3 of the amount of their claims
- In the case of a vote of the holders of debt obligations, a majority representing at least 2/3 of the amount of their claims
- In the case of a vote of holders or options or rights to acquire securities, the majority that would be required under (a) or (c) if those holders had acquired ownership of the securities
- **Remember:** can't be less than 2/3rds but *could be more* – courts will look at approval level to influence their decision making

193:7): If a resolution is required to be voted on pursuant to an order is in writing and signed by all persons entitled to vote
- The meeting required to be held by the order does not need to be held, and
- The resolution is as valid as if it had been passed at a meeting
- For a **written resolution need 100%** of all SHs/D's to sign for it to pass (AB considering changing this)
    - But if you could have just passed by written resolution, it's probably so simple that you don't need a POA

193(9): After the holding of meetings or the submission of written resolutions, the Court will hear the application and may in its discretion:
- Approve the arrangement as proposed by the applicant or as amended by the court, or
- Refuse to approve the arrangement, and make any further order it thinks fit
    - Court has a lot of **authority** to so what they want here

Note: **the requirement that an arrangement be fair and reasonable involves two inquiries: (1) whether the arrangement has a valid business purpose; and (2) whether it resolves the objections of those whose rights are being arranged in a fair and balanced way**

193(10): After an order has been made, the corp must send to the Registrar: (when the POA finishes, this is how it is completed)
- A copy of the order
- Articles of arrangement in the prescribed form
- Articles of amalgamation or a statement of intent to dissolve pursuant to s 212
- The documents required by s 20 and 113 if applicable

193(11): On filing any documents, the Registrar will issue the appropriate certificate in accordance with s 267

193(12): An arrangement becomes effective:
- On the date shown in the certificate issued, or
- If no certificate is required, on the date the documents are filed

193(13): An arrangement as approved by the Court is binding on the corp and all other persons
- Arrangement is **binding** – once the court makes its determination, there is no going back (no unwinding or changing)

Unit 2: Preparing and Setting the Sale Terms

PREPARING A BUSINESS FOR SALE

Remember:
- Shares = capital property
- **Active business** – a business that actually does something, provides a service (e.g. consulting, manufacturing, etc.)
- **Passive business** – doesn't actually create or provide anything of its own; just an investment company

Lifetime Capital Gains Exemption

- Capital gains are applicable to the sale of shares – when you do a transaction and sell capital property (i.e. shares) there is a tax rate attached (50% in pocket, 50% subject to tax)
- Exemption is only available on a share transaction, not an asset deal
    - About how much money you get to put in your pocket as a vendor
- Exemption of up to **$892, 218 in 2021** of capital gains
    - This is tax planning, not tax avoidance
    - Designed to encourage active business – aimed to promote investment, promote small businesses
- Increase in the after-tax return on the sale of shares (capital gain) under s 110.6 of the ITA
    - Capital gains (taxed at ½ the rate of ordinary income)
- One time use in an individual's lifetime BUT can use the gain again if the limit rises or if you only have used part of it
    - I.e. can apply multiple exempt amounts at different times, but in total can only use $892, 218 once per lifetime

Requirements for using the Lifetime Capital Gains Exemption

1. The **vendor must be a Canadian resident individual** (NOT available to corporations, partnerships, trusts)
    - Must be a flesh and blood person
2. The vendor must have **disposed of shares of a Canadian Controlled Private Corporation (CCPC)**
    - CCPC = a corporation not controlled by non-residents or a public company
        - Not a corporate tax benefit! If your vendor is a company, this is not available
    - Exemption *only applies to the disposition of shares* – not available to asset disposition (but could structure a "synthetic share" transaction (e.g. hybrid transaction) to take advantage of the exemption
3. Determination test time – **AT TIME OF SALE at least 90% of assets were used in an active business in Canada**
    - I.e. used to earn active business income (not passive investment income)
    - Time of sale = when you closed the deal/exchanged consideration in exchange for the shares
        - E.g. owning real estate is passive
        - Cash is *not* an active asset
        - As lawyers, need to identify when we sell shares what percentage is active – might have to do some purging to meet this threshold
4. The **vendor held the shares disposed of for 24 months prior to the sale**
    - Legislation designed for *long term* investment
5. Holding period test: at all times in the **24 months before the sale, at least 50% of the assets were used in an active business in Canada**
6. If ANY of these 5 factors are not met, then no capital gains exemption

QSBC Purification

- Purpose: to help meet the Determination Time Test (90%) and Holding Period Test (50%)
- **"Purification": by increasing the percentage of "good assets" and/or removing "bad assets" prior to the sale (if above 90% [DTT]) and in some instances at least 24 months prior (if below 50% [HPT])**
    - Good assets: assets used to carry on the business and earn an active business income
        - Include: inventory, equipment, working capital (i.e. cash to pay employees – can't be general/excess cash)
    - Bad assets: assets used to earn passive investment income that do not help your client meet their exemption
        - Include: excess cash, rental property (only if the property isn't considered inventory – e.g. if there is a company whose sole operation is the rental of properties, then the properties would be inventory and "good" assets)
    - Whether an asset will be considered inventory depends on the facts – depends on the nature of the company
        - *If the property can be considered inventory – good asset*
        - **Shares are considered capital assets ("good assets") for the purposes of this course**
- Planning tool:
    - Always thing about a client's "exit strategy"
    - E.g. if you have a private company, need to plan ahead when you want to exit so you can start making changes

Purification strategies to help meet the Lifetime Cap Gain Exemption tests include:

1. **Reduction of "bad assets" (taking money out of the company and reducing the company's assets)**
    - Payment of dividends/capital dividends – dividend out the assets
    - Return of capital or redemption of shares
    - Repayment of shareholder loans and payment of other liabilities – getting rid of debt
    - Payment of bonuses
2. **Raising "good assets" (keeping money in the company, just redistributing it)**
    - Purchase of active business assets (i.e. equipment, inventory, etc.) – taking money out of the corp and redistributing it

Business Clean-up (Seller Side Due Diligence)

Overall: fix and solve problems, make the business more "sellable" – this should always be one of the first questions you have (how are the records? What shape is the business in?)

1. General
2. Corporate Records
3. Protecting and Account for Assets
4. Removing Liabilities and Impediments to Sale
5. Working Capital
6. Employees
7. Contracts
8. Customers and Suppliers
9. Privacy

General

- **Rationale for business clean-up:** may increase the value, aid in obtaining financing, and/or increase the chances of sale
- **How?** Owner should put themselves in the shoes of the purchaser:
    - What things might cause a purchaser to be concerned?
    - What information will a purchaser ask for in the course in due diligence?
    - What information will a purchaser need to evaluate the risks and strengths (i.e. various liabilities of the business and assets such as customer and supplier contracts)?
- Example: do NOT use old contracts that have expired, instead use new and active ones
    - Identify things that are missing (e.g. meeting minutes)
- **Time commitment:**
    - Start this early so when you get closer to the sale you can be more organized and have the ability to continue operating the business (not focusing all your resources and time on this alone)
    - Do clean-up proactively over a period of time before any proposed sale – don't wait until there is a deal that you need to act on quickly, because then it can be hard to get all of this done

Corporate Records – Minute Books

- The minute books record the existence and activities of the corporation
- ***ABCA* s 6**: **requires minute books to be kept up to date**
- Minute books usually contain the following:
    - Articles
    - Bylaws
    - Any USAs
    - Extra-provincial registrations
    - Minutes of directors or SHs meetings or written resolutions in lieu of such meeting
        - Need to make sure all major SH and director decisions are documented in the minute book, whether through meeting minutes or resolutions in lieu of minutes
    - Director and officer registers
    - Shareholder registers
    - Share transfer ledgers (so you *know who* has the shares)
    - Copies of forms filed with government agencies
- **Minute book deficiencies:**
    - Deficiencies make it difficult to reconstruct the history and past activities of the corp
        - E.g. directors and officers that should have signed resolutions and other documents in the past may no longer be available
    - Updating a minute book is relatively inexpensive and can avoid delays and unnecessary legal costs in the future, particularly in the course of audits, financings or other transactions
- **Minute book rectifications:**
    - Fact specific, for example:
        - If resolutions are missing – may be possible to **re-execute resolutions**
            - *BUT still need consent and signature of involved parties*
            - Parties may have passed away, are otherwise unavailable, are now on bad terms with the company, etc.
        - If annual resolutions and filings are neglected – can then be executed and the corporate registry updated – but might need a **ratification resolution**

- Ratification resolutions could be **challenged** by former shareholders/directors depending on the circumstances
- E.g. if a former SH challenged the election of a director, or the waiver of audit requirements in respect of which a ratification resolution was passed while that person was a shareholder

Protecting and Accounting for Assets

- The value of the business may be dependent on the value of its assets, therefore:
  - Clean and repair equipment and premise
    - Unclean premises and poorly maintained equipment are red flags that buyers may assume are indicative or more serious problems
  - Protect intangible assets such as IP by filing trademark registrations and patents, securing assignments of copyrights from contractors, waiver of moral rights from employees or contractors
    - Make sure no other claim is on the IP, that they actually own it
    - Vendor will have to give a representation or warranty on it
  - Other assets:
    - Assets are critical because this is ultimately what you're buying regardless of the type of deal
    - Understand what the assets are, where they are located, how they can be accessed
    - If a listing of assets is required, good to start building this early
- Computer systems are often critical to a business – look at updates, anti-virus / anti-malware software / open-source code

Removing Liabilities and Impediments to Sale

- Liens and PPSA registration
  - Seek discharges if possible
- Litigation
  - Seek discontinuance, settlement if possible
- Payout letters
  - Need to understand what has to be paid at closing to release the security so it can be sold free from the security
  - If bank financing is in place, payout letters will be required and should be requested early
- Guarantees
  - Terminate / remove if possible
- Environmental liabilities
  - Consider assessments if there is possible contamination

Note: whenever you need to go to a third party for consent (e.g. lease involved, payout letter) you need to plan ahead because it can take a long amount of time

Working Capital Issues

- Determine "working capital" needs/deficiencies (how much money the company has day to day)
  - Working capital: generally means current assets minus current liabilities
  - Includes current float/cash to keep the business running (to pay bills, employers, suppliers, etc.)
- Can help client by looking at things that would be a drag on working capital - clean up obsolete inventory, uncollectable accounts receivable, etc.

Employee Issues

- Often the most challenging and time-consuming type of issues
- Important because there can be entire transactions based upon obtaining key employees
  - I.e. when you do a share sale you take all the employees of the company
  - I.e. for an asset sale, you can pick and choose which employees, if any, you want to take/transfer/assign
    - **Note**: under an asset sale, if an employee transfers to the new company, the agreements they signed with the vendor company still govern
- **Employees vs independent contractors:**
  - Ensure proper clarification – is the person actually an employee or an independent contractor?
  - Different requirements for both, e.g. no severance obligations for contractors
- Up to date **employment records:**
  - Purchaser will need to know the salary, benefits and vacation time/pay, disabilities, etc.
- **Unions:**
  - Any labour grievances or union issues
- **Employee benefit plans:**
  - Includes group benefit plans, pension plans, group RRSPs, etc.
  - Need to know what liabilities are attached to the employees. Do they have defined benefit pension plans, etc.

- **Stock options or employee option plans:**
    - Check if there are any stock options or other employee option plans – need to know what conditions are attached
    - Golden parachute clause: on change of control, all options vest immediately or bonus; can be significant financial burden on the company if they decide to sell
- **Vacation and sick leave records and policies should be up to date**
- **Employee agreements:**
    - Make sure that they are sufficient to avoid issues in the event employees choose to leave like:
        - Non-compete, non-solicit, confidentiality, change of control (golden parachute)
        - Especially in a merger of two companies with similar types of employees, and employees know they will lose their jobs
    - Could be obligations that are inherited by the purchaser, or paid by the company

Contracts

- Is there a list of all the contracts?
- Which are the **material** contracts?
    - E.g. key supplier, renew key contracts
- Written/term/termination – make oral contracts written, set terms and requirements for termination
- **Consents to transfer such contracts**
    - I.e. if they need assignment, consent, or a change of control consent to transfer
    - **Assignment**
        - Asset transaction
        - May need consent to assign depending on if there is an assignment provision in the contract
    - **Change of control**
        - Share transaction
        - There could be a change of control provision barring change of control
    - Are the contracts assignable/transferable? Can you make them so that they are?

Customers and Suppliers

- Purchasers will want to know details about relationships
    - Relationships make up part of goodwill
    - Who are the customers? Who are the suppliers? Who does the company depend on?
- Consider how customers and suppliers will be informed
    - May want to reach out to them to help smooth the transaction. Don't want suppliers or customers to jump ship when they hear of the sale
    - Vendors may stay on post-sale in a type of consulting relationship to normalize relationships with third parties

Privacy

- *Personal Information Protection and Electronic Documents Act* (Canada)
    - No blanket exemption permitting disclosure of personal information for the purposes of purchase/sale due diligence
        - I.e. no disclosure of personal info for purposes of DD by prospective purchaser during the course of the sale of business
    - BUT the federal Privacy Commissioner's Office has indicated that there is an **implied consent for personal information to be disclosed for limited purposes** in the course of the sale of a business or a financing
- **Alberta and BC have exemptions for business transactions**
    - A limited about of relevant personal information may be disclosed for the purpose of a transaction, but only information that's actually *relevant* to the transaction
    - Only provides the purchaser with the personal info actually necessary to effect the transaction
- **Limit disclosure of personal information about customers and employees**
    - Often personal info can be redacted as it is not critical to the deal or due diligence
    - I.e. disclose the least amount of personal information possible
- **Ensure privacy police of business is up to date**
    - And allows transfer of personal info in the event of the sale of a business

Confidential Information Memorandum (CIM)

- **Generally used in a <u>competitive bid process</u> or where a <u>broker is involved</u>**
    - Used when a seller doesn't necessarily know who they want to sell their company to and what amount or money potential purchasers would be willing to pay
    - CIM is really just a big marketing packet, typically put together by investment bankers
- **The CIM provides information to generate an initial offer:**
    - **STEP 1: get a broker to send out "teaser" to potential buyers (brokers have lists of potential buyers)**
        - Teaser provides a little bit of info about the company to help get an idea of who may be interested
        - More of a marketing type of document usually prepared by investment bankers/brokers
        - Info may include: what industry the company is in, maybe the company's name (but not always)
        - Based on this limited info, can assess which potential purchasers are interested and want more info
    - **STEP 2: enter into a confidentiality agreement between prospective buyer(s) and vendor**
        - Ensure confidential info is not used for any purpose other than the transaction in question
        - Ensures that you have legal rights of protection in the event that there is a breach of the confidentiality agreement
        - One-way CA: info seller is giving to buyer; two-way CA: both parties sharing info
        - Duration: if the agreement is silent on the matter, then the duration is infinite
        - Requirements to return or destroy info on conclusions of negotiations or termination
    - **STEP 3: enter into a Confidential Information Memorandum – give additional info to the potential buyer(s) and get an idea of how much they would be willing to pay**
        - Provides enough info to generate an initial offer (highlights attractive attributes and justifies negatives
        - From the CIM the seller will want to gauge the type of buyer the potential purchaser is – seller wants to know:
            - What the potential purchaser is willing to pay; and
            - How many changes they want to make to the purchase agreement template you provided
                - If they require significant changes to the terms, you may prefer to take a lower price from a bidder whose proposed purchase agreement is more in line with the draft you offered (easier to negotiate with them)
    - **STEP 4: potential bidder places an indicative bid**
        - Vendor picks 2 or 3 vendors to start the process with
        - If the bidder likes the CIM, they place an indicative bid = an expression of an early offer or price that indicates what someone might be willing to pay for a business or for specific assets
        - Not definitive
    - **STEP 5: enter into a share purchase agreement with the bidder and close the deal**

- Typically a **CIM will NOT include a purchase price,** but provides the prospective buyer **sufficient info to value the acquisition**
    - It is NOT a contract, it is purely informational
- A CIM should **articulate all of the company's attributes** in order to fetch a premium valuation
- CIM generally includes a description and commentary of:
    - Top customers and suppliers;
    - Summary of financial results and projections;
    - List of competitors and summary of opportunities in the marketplace;
    - Ability to plan and achieve future projections;
    - Future growth opportunities;
    - Barriers to entry from competitors;
    - Strength of management team; and
    - Scalability of operations

- Generally two types of purchasers: **strategic purchasers** and **private equity investors**
    - **Strategic purchaser:**
        - Are in the industry, have operational expertise
        - Likely interested in customers and suppliers, market share, etc.
        - Since they are already in the industry there may be a lot of redundancy in management, so employment agreements are important to be able to terminate those employees
    - **Private equity purchaser:**
        - Do not have operational expertise, so need strong management and team/employees
    - Important to understand who you're pitching to – in the CIM you're pitching to both types of purchasers, so make sure to *include things that would interest both groups*

Letter of Intent (LOI)

General

- More applicable for when the vendor has **already lined up a purchaser**
    - An LOI is a lot less competitive than a CIM – CIM is a competitive process, whereas an LOI is a more private, less competitive matter created between the two parties (potential purchaser and seller)
    - Usually for a smaller purchase – i.e. $50 million
- Can be called a "memorandum of understanding" (MOU)
    - A term sheet is generally a more informal, one-page document that may be used in financing
    - NOT a sale document
- **Process:**
    - Vendor finds potential buyer
    - Potential buyer and vendor draft an LOI between themselves that is **intended to frame the terms of a potential future agreement** if the purchaser chooses to buy the company after doing due diligence
        - Note: **first step** is to sign a confidentiality agreement (below)
- **Useful to frame the parameters of the deal**
    - Demonstrates the parties agreement to certain key terms for the transaction
    - Need to have some parameters on the deal terms to move forward, but need some flexibility since due diligence hasn't yet been completed (a way to bridge expectations)
    - Purchaser and vendor should have a good idea coming in as to what the major terms of the deal are expected to be
        - Otherwise, the lawyers will spin their wheels and bill a lot of fees that the client could have otherwise avoided
- **Can be binding LOI or non-binding LOI (generally, non-binding)**
    - Binding LOI: do this where you know exactly what you're buying
    - Non-binding LOI: do this where you haven't done due diligence yet
        - Goal is to get parties communicating and see if they're on the same page, but at the same time don't want it to be binding completely so there is freedom to negotiate
    - LOIs typically contain both non-binding and binding provisions
- **Use caution to ensure it is not a binding purchase agreement**
    - The title is irrelevant if the conditions for a contract are met
    - Make sure it can't be mistaken for an offer
        - LOIs should state in clear and unambiguous language that it is non-binding
    - Clearly state the conditions under which parties intend to be bound
    - Watch language used to make sure it is clear ("would be" vs "will; "it is intended" vs "it is agreed")

Common Non-Binding Provisions

- The **subject matter** of the sale
    - E.g. "it is our *intention* to purchase all the shares of the target co"
- **Structure** (asset vs share deal)
- The **price and terms** of payment
- Key **representations** and **warranties**
- The **material conditions of closing**
    - Positive and negative covenants
- Can also include **indemnification provisions**
    - What happens if the deal goes badly
    - Idea is that these terms set up the framework for a future deal – parties should be flexible as the deal progresses
- Non-binding terms are used to come to a general agreement on what should be in a purchase agreement, but parties need to be prepared to be flexible as the deal progresses

Common Binding Provisions

These are typically in all LOIs whether binding or non-binding

1. **Exclusivity**
    - A period of exclusivity in dealing with a particular buyer ("**no-shop**")
    - Can include "fiduciary out" clause for the vendor, and a "break free and right to match" clause for purchaser
    - Very important for the purchaser – while the purchaser is spending time and money investigating whether they want to buy the TC, the TC can't sell to another party (both shares and assets)
    - Exclusivity agreement may provide the potential purchaser with the option to match an unsolicited offer, or may prohibit all outside offers during the period which the LOI is in place – depends on *drafting*
2. **Access for due diligence**
3. **Allocation of responsibility for expenses involved in closing the transaction**

    - E.g. if you really want to do the deal, say you will pay for the first bit of the transaction
4. **Rules for public announcements**
    - E.g. disclosure requirements under securities law for public companies
5. **Drop dead date**
    - Outside "drop dead" date to enter into a definitive purchase agreement
    - Bars the other party from stalling for a better deal
6. **Expense reimbursement and work fee if the transaction doesn't proceed**
    - Possibly break-up fees
    - If the deal doesn't close because of something the other side does, then they must pay a break-up fee
7. **Confidentiality provisions**
    - Built right into the LOI if a separate confidentiality agreement has not already been executed
    - Can also have a standalone confidentiality agreement outside of the LOI
    - Parties may enter into a confidentiality agreement, then the vendor will disclose some info (at least enough for the purchaser to formulate an LOI), then after the LOI is entered into, full disclosure is provided
8. **Non-solicit of customers and employees**
    - Can also include this in a separate confidentiality agreement
    - I.e. don't exploit confidential info like employee salaries or customer base to steal customers / employees
9. **Conduct of the business in the ordinary course**
10. **Some boilerplate provisions**
    - E.g. agreement governed by the law of AB

LOI or Contract?

- Determined by **content not by name**
- The name (calling it an LOI) is irrelevant if the conditions for a contract are met
- Whether the LOI is a binding agreement is determined by resorting to the basic principles of contract law (Babe)
    - An invitation to treat is NOT binding – an ITT expresses interest in a transaction and in further negotiations, but is subject to the creation of a formal binding documentation upon the conclusion of negotiations
- Don't want your LOI *as a whole* to be considered a binding contract
    - Purchaser will generally be the most hurt if the LOI is deemed to be binding

Best Practices

- **LOI should state in clear, simple and unambiguous language that it is non-binding** (if that is the intent)
- Clearly state conditions under which the parties intend to be bound
- Drafting consequences – be as clear as you can
    - "non-binding provisions are set forth in paragraphs…"; "binding provisions are…"
    - "purpose of this letter is to set out mutual understanding which will provide for…" as opposed to "purchaser *shall*"
    - "would be" vs. "will" or "shall"; "this letter" vs. "this agreement"; "it is intended" vs. "it is agreed"

Disclosure Requirements under Securities Law

- Material change or a decision to implement a material change
- Special considerations apply to public companies that are subject to continuous disclosure

Confidentiality Agreements

Key terms include:

1. Purpose and permitted uses
2. Information covered
3. Non-solicit
4. Duration
5. Remedies

General

- Standard in Canada before discussing a deal
- **Purpose:** ensures that all confidential info is held in confidence and not used for any purpose other than the transaction in question
    - Very important in protecting the vendor's information from being abused
- Set out the following:
    - **(1) what information is confidential; and**
    - **(2) the terms upon which confidential information can be shared**

- Often deal with the non-solicitation of employees and customers for a stipulated period of time, among other issues
    - May include **remedies** available in the event the prospective purchaser misuses information
    - Many are **"catch and release"** – take a broad approach initially and "release" anything down below in the agreement
- Note: sometimes parties try and put other provisions in here that go to the *deal itself* – e.g. exclusivity, non-complete clause
    - This is usually not a good idea because this is supposed to deal about the information, not about lasting obligations
    - At this point there isn't even a deal, so no point in including these
- Note: when doing a deal with an existing relationship company, if they already have a CA in place the agreement should *still be reviewed* because it might cover something completely different
    - Make sure the purpose it was intended for under that relationship applies here – if not, need to amend or replace

Purpose and Permitted Uses

- Purpose is to facilitate due diligence
    - Vendor must disclose information for a prospective purchaser to consider a bid, but this needs to be balanced with the need to keep information controlled and protected from abuse
- Temporary permission to use (unless deal proceeds) controls exchange of information
    - No transfer of ownership of this info – similar to a limited license
    - As recipient you get no rights in the information
- **Permitted use should be drafted with a limited scope so as to restrict use and protect disclosing party**
    - Should not be usable for another deal
    - Limit scope to include info only relevant to allow the prospective purchaser to evaluate the potential purchase of the company

Information Covered (broad)

- **(1) Confidential information:**
    - This typically includes:
        - *All information* in any form (written/oral) obtained by the receiving party in the context of the transaction
        - Derivatives of such info (e.g. analysis, notes/other documents prepared by receiving party based on such info)
    - **Exclusions:**
        - **Publicly available information**
            - Information that is or becomes publicly available through no fault of the receiving party
            - If info is already out in the public domain, makes no sense to protect its confidentiality
        - **Information already known to the receiving party**
            - Where the receiving party can establish that information is already known to it at the time of its disclosure and it is not known by the receiving party to be the subject of an obligation of confidence
        - **Information was independently developed**
            - Receiving party can establish that the information was independently developed without any use of or reference to the confidential information
        - **Third party info**
            - Receiving party receives information without an obligation of confidence of any kind from a third party (and in possession of such third party free of any obligation of confidence)
        - **Permitted disclosures**
            - May want exceptions that allow the prospective purchaser to disclose information to their bank, investors, lawyers, etc.

- **(2) Confidentiality Obligations:**
    - Typically includes:
        - **(1)** No use of information other than permitted use (i.e. for evaluating a transaction)
            - Need to specify why and how the information can be used, purposes for which it is permitted
        - **(2)** Maintain the confidentiality of the information
            - How confidential it has to be, what measures must be in place
        - **(3)** Maintain appropriate security measures and manage information flow
            - Standard of care is *reasonableness*
            - Treat it as if it was your own confidential information
            - Typical to say you give it the same security as you'd give your own info, but depending on what it is there might be enhanced security (e.g. if IP is involved)
        - **(4)** Confidential considering the deal or entering into the confidentiality agreement

- **Permitted disclosures:**
  - (1) Lawyers, (2) accountants, (3) disclosure that is legally required pursuant to a court order, securities law or stock exchange rules, or regulators
    - Financing may be an issue as *target may not want information disclosed* to lenders
    - For these, the disclosing party will usually require written notice and opportunity to seek a protective order or other appropriate remedy (so that they can ensure as little information as possible is disclosed)
  - Where there are multiple parties, can:
    - (1) Sign a separate CA with that consultant;
    - (2) Sign a joinder – sign onto the main CA; or
    - (3) Some parties have their own confidentiality agreements (like lawyers)
  - The main party can still be **primarily liable** if, e.g. a consultant breaches the CA – this is why the main party **needs to impose CA's on these parties at least as stringent as the primary agreement**
  - Always consider what other parties might be involved

- **(3) Exclusions to confidentiality requirements**
  - Disclosure that is legally required pursuant to a court order
    - To the extent legally permitted, the disclosing party will usually require written notice and an opportunity to seek a protective order or other appropriate remedy
    - General process is that the prospective purchaser would have to tell the disclosing party to give the disclosing party as much notice as possible so they could make a protective order application to the court
  - Carve-outs for disclosure required by securities law or stock exchange rule
    - Don't want to be in a position where you have to breach securities law or a court order
  - Carve-outs for disclosure required by regulators

- **(4) Non-solicit**
  - Prevents purchasers from contacting customers, suppliers, or hiring employees for stipulated periods of time
    - I.e. no poaching
  - Often there may be a number of exceptions including responding to ads, use of a headhunter, etc.

- **(5) Remedies**
  - Particularly where there is an indemnity clause in the CA
  - **Damages:**
    - Can sue for breach of contract
    - Because the CA = contract
  - **Injunction:**
    - Prevents the party from disclosing information
    - The ability to go after equitable relief is a key provision to have in a confidentiality agreement
    - Why?
      - (1) Because it is difficult to immediately quantify the type of damages (loss or reputation, etc.) and the scope of damages; and
      - (2) Because it allows you to stop the party immediately and seek damages later
        - The remedy process is long – the more information that is leaked, the more damages occur and the harder the quantification
        - Better to stop the dissemination of that information than wait and seek damages

- **(6) Duration**
  - Often indefinite, or between 1 and 2 years
  - Often depends on the nature of the items in question
    - E.g. technology companies have a shorter period because of the evolving nature of the industry
  - If the agreement is **silent** on the matter – then the duration is infinite
  - Requirements to return or destroy info on conclusion of negotiations or termination

Unit 3: Duties of Directors in Acquisitions

(1) To manage or supervise management

- ***ABCA* s 101:** subject to any unanimous shareholder agreement, the directors shall manage or supervise the management of the business and affairs of a corporation
    - Directors have ultimate responsibility for management
        - They have an *enhanced fiduciary relationship* to the corporation
    - No definition of "business" in the *ABCA*
        - But from the case law/statutory interpretation, "business" is about *what the company does* (not the relationships)
    - **"Subject to any USA"**
        - Very important carve out
        - Can use a USA to give SHs virtually all decision rights
        - Then there is no conflict between the director having a fiduciary duty to the company and have to make a decision that could put them in conflict with this
    - **Sec 1(a):**
        - "Affairs" means the **relationships** among a corporation, its affiliates, and the SHs, directors and officers of those corporate bodies, but **doesn't include the business** carried on by those corporate bodies
            - I.e. affairs = manage *relationships* between/among many stakeholders in an enterprise
            - Directors are permitted to delegate responsibility to officers (s 121)
                - In many private companies, directors will also be officers
                - Will see more independent directors in public companies

(2) Duty of loyalty and good faith

***ABCA* s 122(1)(a):** every director and officer of a corporation in exercising their duties shall act **honestly and in good faith with a view to the best interests of the corporation**

- **Directors owe a fiduciary duty to the corporation**
    - Ask: *is the acquisition proposal in the best interests of the corporation?*
    - In considering the best interests of the corporation, it *may* be appropriate to consider the interests of particular groups of stakeholders to inform the decision (***BCE***)
        - Shareholders
        - Employees
        - Suppliers
        - Creditors
        - Consumers
        - Governments
    - Duty owed to the corp often co-exist with the interests of the stakeholders – but this is *not* always the case
        - In ***BCE*** – court held that directors don't owe duty to the debenture holders but must consider their interest
            - This doesn't mean they have to act in their best interest
    - **Breach:**
        - Generally requires some type of bad behaviour or self-serving un-savvy behaviour
        - But fiduciary duty can also be breached through not acting in the best interests of the corp (not acting to maximize value)

(3) Maximizing the value of the corporation

- Ask: *what do the directors have to do to get as much value for the corporation as they can?*
- **Duty of loyalty and good faith:**
    - Duty of loyalty and good faith generally requires directors to act to maximize value of the corporation
    - "The best interests of the corporation" means "maximization of the value of the corporation" (***Peoples***)
    - "Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation" (***BCE***)
- **When ownership is in play**
    - If the ownership of a corporation is in "play", shareholders may develop expectation to maximize short term value (i.e. typical way to hold an "auction" for the highest bidder)
    - Play = when the market knows that the company is looking to sell/hostile takeover/for potential buyers

    - Auction: holding an action is usually a good method to "maximize value" in the context of a potential sale of the corporation – directors can consider the terms of potential bids, not just the price
        - But in accepting a bid, the bid should be somewhere in the range of what an appraisal might come up with
- **Informed process**
    - Directors must follow an informed process to reach a reasonable decision on the advantages and disadvantages of the proposed transaction
    - Reasonable is anything that treats the stakeholders *fairly* (***BCE***)
- **Conflict & BJR**
    - If there is conflict between maximizing value and reasonable expectations of other stakeholders, directors can exercise their **business judgment in good faith** and on reasonable grounds to balance the competing interests and determine the "best interest" of the corporation (***BCE***)
    - Note: if in breach of fiduciary duty because not acting in the best interest of the corporation, then the BJR may apply
        - Decisions relating to "maximizing value" are given deference as long as they lie within a range of reasonable alternatives (***BCE***)
        - This is high deference but not *unfettered*, directors still have to show their due diligence and that they're making a decision on good faith, reasonable grounds, etc.
        - Courts usually give deference because if the director is doing their job, they are in the best place to make the decision

(4) Avoidance of conflicts

- Duty is owed to the corporation, even in the event that the interests of corporate stakeholders' conflict (***BCE***)
    - Directors may also have to make decisions that benefit some stakeholders at the expense of others
    - This is allowed as long as the decision was in the best interest of the corporation
- Duty of loyalty requires directors to avoid conflicts of interest that would or could diminish, or be perceived to diminish, a director's ability to consider only the "best interest" of the corporation
    - *Doesn't have to be an actual conflict to be a problem* – sometimes can just be a potential conflict, or that the director's judgment is impaired
        - When they can't make a reasonable or good faith determination of the corporation's interest
        - E.g. self-dealing
        - E.g. if the director was financially interested in the proposed acquisition (bonus pay tied to acquisition)
    - Limited exceptions: board can set their own renumeration; board can declare dividends even if they're also stakeholders – these circumstances are *not* considered to be conflicts

(5) Duty of care

- ***ABCA* s 122(1)(b):** every director and officer of a corporation in exercising their duties shall exercise the care, diligence and skill that a **reasonably prudent person** would exercise in **comparable circumstances**
    - An objective standard
    - ***BCE*** requires this standard
- **Requirements:**
    - Duty requires that directors be fully **informed,** fully **discuss** or **consider** the issues, and have **independence** of mind
    - Different groups may need to be considered, have you determined who they are?
    - How to document?
    - Make sure director clients have put their mind to this – this standard of care is hand in hand with their duties
- **Governs the *process* by which a director must make a decision, not the decision itself**
    - To become informed, directors may have a duty to seek expert advice, depending on the expertise of the director and the nature of the decision
    - The standard is that of a *reasonably prudent person* – so the director must have the skill set to act as such, or must seek the advice of an expert
- **Duty owned not just to the corporation itself, but a broad, more open-ended set of stakeholders**

(6) Business judgment and reliance on management advisors

- ***ABCA* s 123:** a director is NOT liable under s 118 and has complied with their duties under s 122 if the director exercises the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, including reliance in good faith on:
    - (a) **financial statements** of a corp represented to a director by an officer or auditor of the corp
    - (b) an **opinion or report of a lawyer, accountant, engineer, appraiser** or other person whose profession lends credibility to a statement made by that person
    - Directors are also entitled to rely on senior management

- Accords deference to directors' discharge of positive duties (e.g. maximization of the corporation, exercise care)
- Shields directors as long as decisions were made **honestly, reasonably, and in good faith and on reasonable grounds while being informed**
    - Deference so long as director's decision lies within a *range of reasonable alternatives* (***Peoples***)
    - Must act if they become aware of something untoward

- Business judgment rule applies to decisions made in the context of acquisitions and sales:
    - In the public company context, directors must review and advise on takeover bids – must make an assessment and make recommendations to shareholders
    - In the private company context, its more likely that a director is also a shareholder
        - Somewhat lessens the risk that the director's interest is divergent from the shareholder's interest, therefore lessening the risk of properly discharging director obligations
    - Independent legal and financial advisors (among others) can be helpful to enable directors to investigate and consider the circumstances

(7) Conflicts and the role of the special committee

- **ABCA s 120(1):** a director/officer of a corporation shall **disclose in writing** the nature and extent of their interest to the corporation or request to have entered in the minutes of director meetings IF that director is:
    - **(a)** a party to a ***material contract*** (or proposed material contract/transaction) with the corporation; or
    - **(b)** has a ***material interest*** in any person (including a corporation) who is a party to a material contract/transaction with the corporation
- **ABCA s 120(6):** if a director is in conflict under s 120(1) they **shall not vote** to approve the contract/transaction (unless certain circumstances other than an acquisition)
- **Bad faith:** BJR will not shield decisions made in bad faith – does not apply to (i) conflicts (ii) self-dealing or (iii) usurping corporate opportunities
- **Self-dealing:**
    - The statutes provide some flexibility – not an absolute bar on self-dealing
    - Generally directors may engage in self-dealing if they properly disclose their interest and abstain from voting on matters related to the conflict

- **Examples of conflicts in M&A context:**
    - (1) Employment (directorship) could be at stake
        - E.g. director thinks purchaser may want to fire director post-acquirement
    - (2) Having an interest in the potential purchase
        - E.g. director of TargetCo is a 20% owner of PurchasingCo
    - (3) "Golden patriarchates"/parachutes
        - Employment arrangement whereby if there is a change of control in the company, certain key employees may be entitled to cash payouts if they're let go within a certain period of time
        - I.e. guaranteed a large payment/settlement in the event that the corporation is take-over

- **Special Committee**
    - Commonly see this used – made up of a group of independent individuals so that any decisions they make are made objectively (since they don't have a personal stake in the outcome)
        - **Purpose:** to bring a measure of objectivity to the assessment of the transaction
        - Arises definitely for public corporate transactions; sometimes private
    - Members should be free of any conflict of interest (would not typically include members of management, shareholders, or others who may face conflicting duties of loyalty)
    - **Mandate:** to review and consider the takeover bid and to provide the directors with a report and recommendations

        - Often gives the power to: (i) consider and recommend alternative courses of action and (ii) authority to engage experts and advisors
        - Committee makes a recommendation to the board, but the *board still makes the ultimate decision*
    - Meetings: in camera sessions (without management)
        - Don't want outside influence reducing objectivity

- **Defence Tactics**

  Purpose: generally work to *defeat a potential purchaser or prolong the process* to give time to make an informed decision

    - **(1) Standstill Agreements:** (can be its own agreement or part of a confidentiality agreement)
        - What: agreement with the purchaser to get more time
            - Prevents the potential purchaser from going into the market and buying up shares, getting a "toehold" position to have greater influence
        - Process: ask the potential purchaser to slow down or stop their acquisition of ownership (i.e. acquisition of shares) to give TargetCo time to evaluate the situation
            - In exchange, potential purchaser will be compensated if the vendor rejects their offer
                - E.g. vendor will agree to repurchase all of the shares that the purchaser has already obtained at the same price
        - When: used when it's not known whether the bid will be hostile or not

    - **(2) Shareholder Rights Plans (Poison Pills)**
        - What: exercising a poison pill *gives every shareholder except the potential purchaser the right to buy more shares in the company at a discounted rate*
            - This dilutes the shares in the company, making it harder for a hostile takeover to succeed
            - Forces the potential purchaser to buy all the new shares in addition to the already outstanding ones
            - This gives the target company more time to make decisions
                - E.g. company will warn the potential purchaser if they don't give enough time to evaluate bid, the company will exercise
        - Risks:
            - Potential to devalue the company since driving down the price of shares (very risky for public companies)
            - Not very common anymore, very frowned upon
        - Poison pills are allowed as a protective mechanism (to give more time) but not if it prejudices shareholders (i.e. for the purpose of trying to identify potential purchasers, or if shareholders want to sell)

    - **(3) White Knights**
        - What: for situations where the corporation is not happy with a potential bidder – tie them up and support the purchase of a "white knight" – a friendly investor who will acquire the corporation for fair consideration
            - White knight = a better takeover offer (i.e. more favourable terms/willing to preserve core busines)
            - A search to find better terms by going elsewhere, instead of the black knight/hostile potential purchaser
        - Note: last resort, doesn't always work out

    - **(4) Selling the "Crown Jewels"**
        - What: asset transactions granting an option or agreement to sell material assets
            - I.e. instead of having the share deal come in, sell the core assets underneath – remove all the key assets of the company to defeat the purpose of acquiring it
        - Why: to deter the purchaser from buying the company (they would be buying a company with no benefit)
        - Risk: be cautious – is this really the right move? Are we getting more value?

    - **Issuer Bid (rarely used)**
        - Company itself rebuys its shares
        - Rationale: anybody willing to sell shares to a potential purchaser should be willing to sell back to the corporation
            - Shareholders that are left would then be unwilling to sell to the hostile purchaser

BCE Inc v 1976 Debentureholders (2008 SCC)

Leading authority on Plan of Arrangement and Director's Duties

Facts:

- Deals with a leveraged purchase. Only asset of BCE was shares of Bell Canada. Both BCE and Bell had the same directors. Bell had debenture holders (secured loan – contractual agreement) in the amount of $7.2 billion. Debentures contract did not deal with a change in control and did not have any restrictions
- Bids were being entered for BCE. Competitive bid process was undertaken – winning bid required the party to borrow from the bank and required the party to pledge Bell as collateral
- This scheme would have allegedly pushed the value of the existing debentures down 20% since BCE was going to take on $30 billion additional debt, credit rating of debenture would fall

Issue: what is the scope of the director's duties in the context of a proposed acquisition in which the SHs interests (to obtain the highest price/share) conflicted with the interest of the debentureholders (to maintain their credit rating)?

Reasons:

- **Fiduciary duty:**
    - Fiduciary duty is owed to the corp, even in the event of conflicting interests of various stakeholders
        - Fiduciary duty = duty to act honestly and in good faith with a view to the best interests of the corp
        - BUT in considering the best interests of the corporation, it *may also be appropriate for the directors to* ***consider the impact of corporate decisions on some stakeholders***
        - Maximizing value does not necessarily just mean maximizing share value
            - ***Maximizing value is a broader concept***
    - Consider the **interests of all stakeholders, not just shareholders** (e.g. creditors, employees, suppliers, the environment)
    - Respect the legal rights and reasonable expectations of all security-holders and creditors
    - The director's decision regarding the balance of conflicting stakeholder interests will be treated as a matter of **business judgment** and should be respected unless unreasonable or oppressive

- **Oppression:**
    - To prove oppression: (1) must be reasonable expectations of the parties that was not met; and (2) conduct complained of must have amounted to oppression, unfair prejudice or unfair disregard
    - Reasonable expectations: look to whether there was anything the claimant could have done to protect themselves
- **Plan of arrangement:**
    - Where corps are seeking to effect fundamental changes, court will approve the POA if satisfied that:
        - (i) the statutory procedures have been met (special resolution 2/3 majority vote)
        - (ii) the application has been put forth in good faith
        - (iii) the arrangement is fair and reasonable – two-part test
            - (1) Does the arrangement have a valid business purpose?
            - (2) Are the claimants' legal interests being balanced in a fair and reasonable way?
                - Did the directors ask the right questions, manage conflicts, make informed and deliberate decisions, keep records?

Ratio: Debentureholders lose. To fulfill their fiduciary duty to the corp:

- Directors must respect the rights and reasonable expectations of all security holders and creditors
- Directors must consider the interests of all stakeholders
- The director's decision regarding balancing the conflicting stakeholder interests (SHs and creditors) must be treated as a matter of business judgment – decisions respected unless unreasonable (oppressive)
- Need to: ask the right questions, manage conflicts, make informed and deliberate decisions, and keep records

Unit 4: Takeover Bid Requirements and Exemptions

SECURITIES LAW – INTRO

- Securities law in Canada: "co-system" – under provincial jurisdiction (so many statutes and different regulations)
  - National Instruments: all provinces agree to comply
  - Multilateral Instruments: two or more provinces have agreed to comply
  - Practice point:
    - Question should be where is the market base served? But always a division of powers question. While there are a lot of nationalized instruments across Canada, it is not as uniform as other jurisdictions, which makes it more difficult to raise capital in Canada
  - Can't just go and buy shares in any company – rules try to protect investors and lend credibility to the Canadian market

- The *Securities Act* is triggered whenever:
  - (1) Shares are being issued
  - (2) Shares are being repurchased or
  - (3) Buying more than 20% of the company (equity or voting rights) – a takeover bid

- **Reporting issuer:** can issue shares into a public market
  - Must issue shares through a **registered dealer** (i.e. investment bank) – registered with the securities commission
  - A **prospectus** must be used every time the shares are issued (provides "true, full and plain disclosure", all the info someone would need to invest in your company)
    - Note: if that info is wrong, legislation says that the company, directors, etc. are on the hook – if the investor is misled or there is an omission, there is *real recourse* to get money back
  - **Benefits:** raise capital and liquidity (more attractive to investors because easier to (re)sell their shares)
  - **Weakness:** expensive (e.g. must issue prospectus, retain registered dealer, etc.) – long process

- **Prospectus**
  - Very expensive
  - If every company was required to file a prospectus the market would dry up
  - If a prospectus is filed, then *anyone* can buy shares
  - If a company does not/cannot file a prospectus there are certain exemptions that allow people to buy shares in your company
    - If no exemption = can't buy shares

TAKEOVER BID REQUIREMENTS AND EXEMPTIONS

- **Takeover bid [NI 62-104 s 1.1]**
  - An offer to acquire voting securities or equity securities of a class made to one or more persons in the local jurisdiction (or whose last address is in the local jurisdiction) where the securities that are subject to the offer, together with the offeror's existing securities, will constitute 20% or more of the outstanding securities of that class
    - **20% or more of outstanding securities**
      - This *includes what you already have* + anything you are offering to buy
        - E.g. if A owns 15% and offers to buy 5% more = a takeover bid
        - E.g. if A already owns 20% and decides to buy even 1 more share = a takeover bid
      - Why the low threshold of 20%?
        - In a private company you probably don't have control of the company with 20%
        - But in a public sector company, 20% of the company is millions of shares – this is a lot considering how many shares and shareholders
- **Deemed beneficial ownership [NI 62-104 s 1.8]**
  - **(1)** In calculating the number of securities owned by the offeror, include any options that the offeror has the right to exercise **within 60 days**
    - Option to acquire share/security = a right to purchase a share at a (generally) pre-determined price
      - Can exercise the option in the future, subject to rules
    - E.g. X owns 15% and 6% in stock options – deemed to own those securities for the takeover bid calculation
    - E.g. X owns 12% and has an option to acquire 3% within 60 days. X offers to buy 5% more = takeover bid
  - **(2)** If the offeror is acting jointly with another person then the securities owned by that person are included in the calculation
    - Legislation is trying to prevent people from skirting the rules by deeming people to own the shares

        - E.g. X owns 15% + 6% in option, but gives the 6% to his wife = deemed to own 21% in securities
        - E.g. You own 10% and your wife owns 5% and together you buy 5% = takeover bid

- **Note: NI 62-104 Application to Private Companies**
    - Three areas under this NI that apply to private companies:
        - (1) To a merger and acquisition
            - If there is a takeover, it will apply – doesn't matter if public or private
        - (2) If a company buys back one share/unit = issuer bid applies – NI applies
        - (3) Issuing of shares (unit 5)
    - If you do not have a takeover bid, this NI will NOT apply
    - **Takeover bid** (*ABCA*): an offer made by an offeror to acquire all of the shares not already owned by the offeror

EXEMPTIONS FROM THE FORMAL TAKEOVER BID REQUIREMENTS

- Legislation dictates that you must follow the rules of a formal take-over bid process
- Exemptions allow you to avoid the formal take-over bid process, while still increasing ownership more than 20%
- Note: to comply with 62-104 is very onerous, expensive, and not time effective

(1) Normal Course Purchases – *Section 4.1*

- **Overview:** Can buy 5% of these securities over 12 months if there is a published market
- **A takeover bid where :**
    - (i) Number of shares purchased does not exceed 5% of the outstanding shares of that class **within a 12-month period**
    - (ii) The total number of securities purchased in reliance on this exemption in any 12-month period cannot exceed 5% of the outstanding securities at the beginning of that 12-month period
        - I.e. the number of securities purchased doesn't exceed 5% of all the cases of shares within the period
    - (iii) There is a published market AND
    - (iv) Shares are purchased at the prevailing market price
        - I.e. don't pay more for securities than market price (including brokerage fees and actual commission paid
        - E.g. if the market price is $10/share, can't offer someone $14/share just to use this exception
- Allows a SH to **incrementally increase ownership** even if you go over or are already over 20%
    - Less concerning since other SHs can see you trying to acquire, and it gives the market time to react
- Example:
    - Class A has 100 shares and class B has 900 shares = 1000 shares in total
    - Cannot buy more than 5 class A shares and 50 class B shares
    - Cannot buy more than 5%

(2) Private Transaction – *Section 4.2*

- **A takeover bid that:**
    - (1) Is not made to SHs generally;
    - (2) Is not made to more than 5 people; and
    - (3) The price paid does not exceed 115% of the market price (or sometimes value, depending)
- Very common – only applies to private companies
- **Can't circumvent this rule by having others buy**
    - Additional rules have been introduced to avoid direct manipulation of this system
    - Can't aggregate shareholders and then buy from the final five people (can't consolidate)
    - E.g. everyone owns 10% of the company so 4 people sell to A, a different 4 sell to B, etc., so that you end up only having 5 people to buy from
        - I.e. rules preventing SHs all buying different shares from 5 people, and then X buying all the shares of those 5 shareholders. The aggregate cannot be more than 5 people
- **When useful:** can be useful when people have a big position they want to sell
- **Issue:** can be difficult to calculate price
    - Some rules set out in the Act
    - Need to look at the language – different tests in the act, sometime the amount of value and sometimes the value of the market price – terminology has to be clear

(3) Non-Reporting Issuer – *Section 4.3*

- Most common and very broad
- **A takeover bid where:**
  - (1) Offeree is not a reporting issuer (no registered dealer, no prospectus);
  - (2) No published market for the securities; and
  - (3) There are **50 or fewer holders of the class of securities** subject to the offer (excluding current and former employees)
- MOST IMPORTANT SECTION
  - Most private companies fall into this by luck/accident

(4) Foreign Take-Over Bid – *Section 4.4*

- **Overview:** de minimus concept – if less than 10% of Canadians that own or are the beneficial holders and most trading took place outside of Canada, and everyone files bid materials, then you are exempt
- **A take-over bid where:**
  - (i) Canadians own less than 10% of the outstanding securities, based on the registered security holders list;
  - (ii) The offeror reasonably believes that Canadians beneficially own less than 10% of the outstanding securities;
  - (iii) In the past 12 months the greatest volume of trading took place on a market outside of Canada;
  - (iv) Security holders in the local jurisdiction participate in the bid on the terms at least as favourable as offered generally;
  - (v) Offeror files and sends to Canadian security holders a copy of the bid materials or publishes a notice
- Issues:
  - Not common in Canada – more for companies that don't relate to Canada
  - For public co's, the company has no idea who has the shares because the shares are constantly trading, so they issue one global share certificate to a clearing house which then acts to track and trade
    - Don't know the individuals usually, just that they're registered to a certain account
    - Wouldn't likely know if they have less than 10% ownership in Canada – difficult to determine who the beneficial owners are
  - Overall hard exemption to rely on because of these problems
- Note: when conflict between beneficial title and legal title, beneficial title ALWAYS wine – shares act in the same way
  - Registered title = legal title; own legally
  - Beneficial title = might not legally own
  - E.g. RRSP – the account number is the name of the National Bank (legal title) but the beneficial owner is you

(5) De Minimus Exception – *Section 4.5*

- **Overall:** such a small connection to Canada that the security regulator doesn't care – less than 50 security holders in the whole country
- **A take-over bid where:**
  - (1) There are less than 50 security holders in Canada;
  - (2) Security holders in Canada hold less than 2% of the total outstanding securities of that class;
  - (3) Security holders in Canada participate in the bid on terms at least as favourable as offered generally; and
  - (4) The takeover bid materials are filed and sent to the security holders in Canada

TAKEOVER BID REQUIREMENTS

Formal takeover bid: PROCESS:

(1) *Commencement of the bid – (MI 62-104 s 2.9)*

- The bid is commenced by delivering the bid to the security holders, or by way of an advertisement in a newspaper of general and regular paid circulation in the local jurisdiction
  - For advertisement: bid clock starts when advert posted (not when list is requested)
  - For delivering bid: bid clock starts when the list of security holders is requested – must be given within 10 days

(2) *Takeover bid circular*

- The offeror must file the bid and prepare and send a takeover bid circular to the offeree and security holders
- In accordance with Form 62-104F1 (s. 2.10(1))

(3) *Director's circulation*

- Within 15 days of the start of the bid, directors of the offeree must send directors' circulation to security holders recommending to reject or accept the bid
  - Should strike up special committee to do this and get a fairness opinion
- An individual director or officer can send out their own circular

- If there is a change in the information in directors' or officers' circular a notice of change must be sent out
- Directors have to respond with the circular – recommend to accept the bid or not, or that they can't tell at this time
    - Generally before you make the bid you would talk to the directors of the co (don't want to go through this process to find out no one wants you to buy their shares)
    - Could even lock this up before, make sure they would accept at a certain price
- If one director doesn't agree, they can file their own circular
    - Provide reasons why
    - At this point – potential of three circulars before anything even really happens

(4) *Bid must remain open for a period of at least 105 days, subject to certain adjustments*
- The offeror cannot take up (purchase) any securities deposited under the bid unless (1) 105 days have elapsed from the date of the bid; (2) all terms of the bid have been complied with or waived; and (3) more than 50% of the outstanding securities of the class that are subject to the bid have been deposited under the bid and not withdrawn
- This allows others to put in a bid, creates a competitive process and opportunity for the markets to work efficiently
    - Hard for a small corp – wants to do the deal quickly

(5) *If all terms and conditions are satisfied, securities deposited under the bid must be taken up by the offeror within the earlier of:*
- (a) 10 days after the expiry of the bid (if deposited prior to expiry) or 10 days of being deposited (if deposited after first take up)
- (b) In any event, must pay for the securities within 3 business days of being taken up
    - "Provided that the conditions of the bid have been satisfied, the securities that are deposited under the bid must be taken up immediately after the expiry of the bid, if deposited prior to the expiry (subject to certain exceptions)"

(6) *If the bid is varied prior to expiry of the bid (or material change in the information contained in the circular), must send notice*
- "If there is a variation in the bid, or a material change in the information contained in the circular, at any time prior to the expiry of the bid or prior to the expiry of any withdrawal rights, then a news release is issued and a notice of the change is sent to all security holders whose securities have not yet been taken up"

(7) *On expiry of the bid, must issue news release of how many securities were tendered and how many were taken up*
- "If the terms and conditions of the bid have been satisfied or waived, on expiry of the bid the offeror must promptly issue a news release disclosing approximately how many securities were tendered and approximately how many securities will be taken up"

(8) *On the expiry of the bid, must return deposited securities if the take-over bid fails*
- "Following the expiry, if the offeror knows that it will not be taking up securities deposited, it must promptly issue a news release to that effect and return the securities"

(9) *Security holders who have deposited their securities under a bid can withdraw them at any time up to:*
- (a) any time before the securities are actually taken up;
- (b) if the securities have not been paid for within the 3 business weeks of being taken up;
- (c) within 10 days of the notice of a change or variation

(10) *In the event of a withdrawal right arising upon a notice of a change or variation, the right will not apply if (for example):*
- (a) the securities have already been taken up; and
- (b) the variation in the bid consists only of an increase in the consideration offered and the time for deposit is not extended beyond the 10 days required in the case of a variation; or
- (c) the bid is a straight cash bid and the variation is just the waiver of a condition

Overall:
- Rules on how to pay, how the shares can be taken up, what happens if you want to change your bid
- Change in bid term is very transparent, and if there are changes everyone can see/knows
- If you don't follow the process, shares can be taken back
- Overall a transparent and expensive process

<u>Formal Take-Over Bid: RULES</u>

(1) The bid must be **made to all security holders** (that own securities of that class) and **must be offered for identical consideration**
- The same offer must be made to every shareholder
- Doesn't mean that the payment received has to be the same (e.g. can give options for some SHs to be paid in something other than cash)

(2) Any **collateral agreement** that would result in any security holders getting consideration of greater value than offered to other security holders is expressly forbidden

- Make sure you are not circumventing the rule in (1) – don't want a SH receiving some sort of collateral benefit outside of the terms offered to all shareholders
- There are certain exceptions to this rule to do with employee compensation (e.g. golden parachutes) where money might have to be paid out to certain people to effect the share sale
    - A collateral benefit is allowed in certain circumstances, but there are safeguards in place

(3) Between the time that a bid is commenced and when it expires, an offeror **cannot buy any (additional) securities of the target issuer, except through the bid, unless:**

- (a) in the circular (or in a notice of change) it said it was going to do so;
- (b) it **does not buy more than 5%** of the total outstanding securities (links into normal course exception);
- (c) the purchases are made in the normal course on a published market; and
- (d) it issues and files a **press release on each day that it buys securities**
- **Overall:** The bidder is generally restricted to only buying shares under the bid, but the bidder can go and buy shares in the market if the above conditions are met (but these purchases are limited to 5%)

(4) The **bidder cannot sell any securities** of the target during the bid

- If the bidder has taken up shares, the bidder can't sell to someone else until after the bid expires
- Some exceptions – can include in circular – but generally, locked up

(5) From the **commencement of the bid until 20 days after the expiration of the bid, the offeror cannot buy any securities by way of a private transaction exemptions**

- Private transaction exemption is where you can buy from a maximum of 5 shareholders
- Since the bid may change the market price, 20 days allows the price to go back to the natural market price after the bid

(6) If the **offeror has bought any securities in a <u>private transaction</u> within the 90 days prior to the start of the bid,** then the **consideration offered under the bid must be at least equal to the highest consideration** (or cash equivalent) **paid under the private transaction(s)** (max 115% market price), and must offer to purchase a percentage of securities at least

- If you bought under multiple private transactions in the 90 days prior, the bid price must be at least as high as the highest price paid and the offer must be at least for the highest percentage purchased
- Might be a good idea for the bidder to wait 90 days to avoid this rule
    - You've essentially set your *minimum* bid term
    - Need to look backwards with clients – if the company isn't doing well, should wait
- E.g. at 5 days, paid 30% at $8. At 15 days, paid 10% for $10. At 40 days paid 3% at $15 – at 90 days, have to offer at least 30% at $15 for consideration

(7) If the **bid is for less than all of the outstanding securities,** and there are securities tendered for more than the maximum number, then the offeror shall purchase that number from all of the tendering security holders on as **nearly a proportionate basis as possible**, ignoring fractions

- E.g. you're bidding on max 60% of the company, but 80% of the shareholders want to sell, then you must proportionately buy from all shareholders who tendered their shares
    - Out of all the SHs who tendered, must buy the same percentage to get to your total of 60%

(8) If the **bid is conditional upon the offeror getting a minimum number of securities tendered,** and the offeror purchases additional securities outside of the bid, then those additional securities shall be counted towards meeting the minimum requirement, but they will not reduce the amount that the offeror is obligated to take up

- Bidder can't circumvent a condition of its bid by going into the market and buying shares
- Shares bought in the market count towards a bidder's minimum, but not their maximum
- Bidder must be careful to not buy too many shares in the market if they only want a specific max percentage
- Can't change this – once you've hit it, you're locked in

(9) If the **bid includes, in whole or in part, a cash offer – then the offeror is required (prior to the bid) to make adequate arrangements to pay for all the securities that they have offered to acquire.** Form 62-104F1 required the offeror to disclose those arrangements

- Bidder can make a non-cash bid
- But if the bidder makes a cash bid, it will be required to make adequate arrangements to pay for all securities they have offered to acquire
- Want to avoid someone going through this whole process then not having the money to buy – big problem for the market

- Trying to create an equal playing field so if you're a SH and trying to decide between SHs, you know the financial resources and who will be able to follow through

"GOING PRIVATE" TRANSACTIONS

- Going private transactions: transaction(s) that transform a public corp into a private corp (thus eliminating public SHs)
- What if you want to buy 100% of the company but not all shareholders want to sell? Two situations to address this

Compulsory Acquisition

- **ABCA s 195:** gives an offeror the right to compel dissenting security holders to sell their securities (shares) either for the original offer consideration or for "fair value", provided that the offeror acquires at least 90% of the outstanding securities **that they did not already own**
    - Must be a takeover bid (buying 100% of shares) – this is different from a takeover under NI 104
- **Timeline:**
    - Must acquire 90% within the shorter of:
        - (i) 120 days after commencement of the bid; or
        - (ii) before the date specified as expiration of the bid
    - Note: maximum of 180 days – so either 180 days or if the bid was shorter than 120 days, then the number + 60 days
- **Percentage:**
    - Has to be 90% - then can squeeze the remainder out
    - E.g. if you already own 20%, this means you don't own 80% - then you have to acquire **90% of the shares you *don't* own**
    - Don't factor in the shares you already own
- **After the 120 days and you have the 90% threshold hit, you can require the rest to sell**
    - Must give notice to every dissenting SH
    - SHs can either accept the original offer consideration or request the court set FMV (ABCA s 196) but **must sell either way**
    - ***Process:***
        - Send notice to dissenting shareholders
        - Use s 195 – have 60 days after the bid ends or 180 days in total to send out the notice
            - Say you are exercising your rights, then offer everyone a price/share who hasn't sold
        - They either have the right to accept the offer, or reject it and you go to court to figure out the value of the shares
            - Either way, no longer a SH
        - Dissenting SH then has 20 days to elect what to do (sell or court)
        - If no reply – deemed to have accepted the offer
        - If after the SH says they want FMV from court, you have 20 days to apply to a court
            - If you don't do this, then the SH has 20 days to do so
        - If neither do after 40 days – deemed to have accepted the original offer
- **NOTE:** don't have to go after the last 10%, but after the time period has expired, there is no longer an opportunity to do so

Squeeze out Amalgamation

- Most common way to "get someone out" – this is because rather than having the 90% threshold, **only require 2/3rds**
    - Remember: need SH approval by special resolution (2/3rds), SHs have a right to dissent, can go to court and get FMV (**ABCA s 191**)
- **Process:**
    - (1) Acquiring Co comes along and wants to acquire the entire TargetCo
    - (2) Acquirer sets up 100% owned subsidiary, SubCo, for the sole purpose of getting 100% ownership over TargetCo
    - (3) SubCo buys as many shares as possible in the market
        - MUST buy 2/3 (80%) of the shares to control the special resolution
    - (4) Amalgamate SubCo with TargetCo – need shareholder approval to amalgamate
        - Who has to approve?
            - (1) Acquiror because they own 100% of SubCo
            - (2) But since SubCo now owns more than 2/3 of TargetCo, they will vote yes - so amalgamation proceeds
        - SHs have a right to dissent, can court to court to get FMV (**ABCA s 191**)
    - (5) On the amalgamation, change share structure of Amalgamated TargetCo
        - Issue minority SHs of TargetCo 100% redeemable shares (redeemable by TargetCo) and
        - Issue SHs of Acquiror 100% of voting shares (now have 100% of shares instead)

- (5) TargetCo buys back all of the minority SHs redeemable shares
  - Acquiror now owns 100% of all TargetCo shares
  - If minority SHs disagree with the consideration they have dissenter rights – apply to court for FMV under s 191

TAKEOVER BID VS PLAN OF ARRANGEMENT

	Takeover Bids	Plan of Arrangement
Support of Target	- No need for TargetCo Board to support but can be helpful - But more stability - *More advantageous*	- TargetCo Board support is important and necessary all the way through
Flexibility of Structure	- Takeover bids permit acquisition of shares - Can't do anything else other than structural changes/reorganization	- Very flexible – creative in structuring the transaction (can be helpful re: taxes, etc.) - Can include winding up, amalgamation, etc., can put a lot into one structure - *More advantageous*
US Shareholders	- Complex under TB, many rules have to apply	- If SHs of the target are resident in the US, POA offers a major advantage - Because the arrangement is approved by a court, shares issued pursuant to the arrangement are generally exempt from any registration requirements in the US - *More advantageous*
Court Approves	- No approval required by a court in a takeover bid - So no uncertainty regarding arrangement - *More advantageous*	- Subject to court approval, so risk that a court will not approve the transaction - Great deal of uncertainty and don't know what the final arrangement will look like even if it is approved

Unit 5: Statutory Considerations

Overview:

(1) Securities Legislation
(2) Competition Act
(3) Investment Canada Act
(4) Non-Resident Vendors (s 116 ITA)

Note: this is not all of the statutes applicable in m&a transactions

- E.g. environmental statutes, tech legislation for IP, etc.
- Always depends on the nature of the transaction and the parties involved
- Might need a specialist – e.g. real estate lawyers, employment lawyers

SECURITIES LEGISLATION

Security:

- Very broad definition – includes share, note, profit sharing agreement, bond, debenture
- Securities legislation will vary by province – each can implement whatever they want
  - Not to the province's advantage to think "outside" the norm, because often issuers will hit more than one province at a time, thus the legislation is similar
  - May not be able to give legal advice on extra-provincial matters/statutes – may have to engage local counsel
- **Two main issues when purchasing securities (when buying a company):**
  - (1) Do we have a take-over bid?
  - (2) If purchasing securities from a private company, need to find an exemption

Securities legislation is a CLOSED system

- Restricted trading – issuers are not allowed to issue shares/trade unless they:
  - (1) **File a prospectus, OR**
    - Filing a prospectus gets you out of the closed system into the non-exempt market (public market)
  - (2) **Fall within an exemption**
    - If an exemption is used, securities are issued to the exempt (private market)
    - The securities are then stuck in the closed system – must again **find an exemption to re-sell**

Issuing a prospectus

- Prospectus: a large document that offers clear and full disclosure of sufficient detail regarding the company such that you can make an informed decision about whether to invest
  - Means that *anyone* can go and buy those shares because all company info was released
- Inaccuracies:
  - If there are any factually incorrect statements, misrepresentations, misleading statements, or omissions in a prospectus, then the investor is deemed to have relied on them; *issuer may be liable to damages (or right to recission) to investors*
  - This is a codified statutory right – no contractual or tort-related reason needed
  - Why? To keep people from giving inaccurate info and providing relevant info
- Cons: (1) hard to fulfill the requirements (must keep up with constant disclosure); (2) expensive (very difficult for smaller corps)
- Pros: free trade, so easy to trade

Note: if you want to issue NEW shares – need either another prospectus or have to use an exemption

Fall within an exemption (NI 45-106)

- If you don't want/are unable to issue a prospectus, then in order to issue securities you must fall within an exception
- Can't hold securities under an exemption for the benefit of someone else who **doesn't** fall under an exemption
  - Must **purchase as a principal** or disclose who you're buying for
- Essentially: issuing shares for a private company
- **Exemptions:**
  - (1) Capital raising/private placement exemptions
    - (a) Accredited investor exemption
    - (b) Private issuer exemption
    - (c) Friends, Family and Business Associates
    - (d) Offering memorandum
    - (e) Minimum investments
  - (2) Transaction Exemptions
    - (a) Business Combination and Reorganization
    - (b) Asset acquisition
    - (c) Other transaction-related exemptions
  - (3) Trades Issued to and Among Employees, Directors, Etc.
    - (a) Employee, executive officer, director and consultant
    - (b) Trades among employees of a non-reporting issuer

(1) Capital Raising/ Private Placement Exemptions - *applied to help raise capital through equity*

- **(a) Accredited investor exemption – s 2.3**
  - **Rationale:** these individuals have sufficient resources to obtain advice from professionals, and the ability to withstand significant losses with regard to their investment
  - **Filing requirements:** (need to fulfill at least one)
    - (i) an individual (alone or with spouse) has *net financial assets* (only cash and securities, exclude tax) of at least $1,000,000
      - Note: net assets differs from net financial assets – net financial assets are only cash and securities and do not include real estate; net assets could include your house
    - (ii) an individual with *net income before tax* (in the last two years) of at least *$200 000* (or $300 000 combined with spouse) and *reasonably expects to exceed that income level* in the current calendar year
      - Could be a tough determination for some people – consider fluctuating markets, e.g. low oil demand, covid
      - The obligation is on the company to ensure that the person is an accredited investor – company needs to take *reasonable steps* (e.g. explain steps to investor, meet with accountant, etc.)

        - Not a lot of jurisprudence on what might be reasonable – just ensure positive steps are taken
    - (iii) an individual (alone) has *net financial assets* (cash and securities) of at least *$5,000,000*
    - (iv) an individual (alone or with spouse) has net assets of at least $5,000,000
    - (v) a "*person*" (other than an individual) has *net assets* of at least $5,000,000
        - I.e. a corporation, partnership – allows indirect ownership
        - Note: net assets means all assets minus liabilities
        - Individual = a human, not a corp
    - (vi) a person in respect of which *all owners of interests* (except those required to be owned by directors) are *persons that are accredited investors*
        - If ALL owners of a corp are accredited investors, can look through that corporation to them, allowing that corp to buy shares
        - **Facilitates a holdco structure:** holdco itself doesn't meet any of the categories for an accredited investor, but since all the owners of the holdco are accredited investors, then the corp itself is
            - Allows flow-through of accreditor investor exemption
- NOTE: counsel for the issuer of securities being issued via accredited investor exemption must **exercise due diligence** to ensure that the purchasing investor is *actually* an accredited investor

- **(b) Private Issuer Exemption – s 2.4**
    - **Most common** exemption in dealing with companies – most applicable to private companies
    - There are **no filing/reporting requirements**
        - This means that the securities commission doesn't know the company exists and cannot audit you
    - **Need to satisfy <u>all</u> criteria**
        - (i) is *not a reporting issuer* or an investment fund
        - (ii) securities are *subject to transfer restrictions* contained in the issuers constating documents or shareholders agreement (USA)
            - Problem: if people say there are no restrictions on their shares when incorporating their company (often people who don't have counsel) then they opt themselves out of this exemption – challenging to fix
                - Need to include this in articles of incorporation
        - (iii) securities are *held by not more than 50 people*, exclusive of employees and former employees;
        - (iv) has *only distributed* securities to the permitted list of investors:
            - (a) director, officer, employee, founder or control person;
            - (b) spouse, parent, grandparent, brother, sister, child or grandchild of either a director, executive officer, founder, or control person, or of a spouse of such
            - (c) close personal friend or close business associate or a director, executive officer, founder or control person
                - Hard to meet this requirement – have to have a very close connection, genuine relationship
                - Rule of thumb: would this person be a pallbearer at my funeral?
                - Being a relative does not make you a close personal friend or business associate
                - Looking for people who know you well enough to evaluate your **trustworthiness** to make informed investment decisions
            - (d) grandchild of the selling shareholder or the selling shareholder's spouse;
            - (e) a current shareholder;
            - (f) an accredited investor;
                - **This is preferable over 2.3 when you have less than 50 shareholders and meet other criteria – don't have to file anything**
            - (g) a person of which a majority of voting SHs or directors are persons described above;
                - Under this section **only a *majority* need to be accredited investors** (unlike 2.3 where you needed all the people in the holdco to be accredited)
                - These rules are more relaxed because there are other restrictions in place
            - (h) a person that is "not the public"
                - Difficult to rely on – avoid if you can
                - But – can be useful if you have a client who has someone who is not a "close personal friend", can use this as a backup argument to say they are a person "not the public"
                - Not a lot of jurisprudence or guidelines on the standard – don't want to spend time and money fighting the securities commission arguing
    - Pros:
        - Always better to not have to file a report with the securities commission
        - Need to talk to client about this – puts them on the radar, costs some money for the fee

        - This is why the private issuer exemption is good – **no report, no fees**

- **(c) Friends, Family and Business Associates ("FF&BA") – 2.5**
    - Contains many of the same relationships as the private issuer exemption, but:
        - **Not limited to 50 SHs** like private issuer exemption
        - **Not accredited investor category** like private issuer exemption
        - **Don't need a restriction on transfer of shares**
        - **Must file a report with securities commission**
    - Applies when you can't meet all the private issuer criteria – often used for wealthy families
    - **Criteria:**
        - A director, executive officer or control person of the issuer or an affiliate of the issuer;
        - A spouse, parent, grandparent, brother, sister, child or grandchild of a director, executive officer or control person;
        - A parent, grandparent, brother, sister, child/grandchild of a spouse of a director, executive officer or control person;
        - A close personal friend or a close business associate of a director, executive officer or control person;
        - A founder of the issuer or a spouse, parent, grandparent, brother, sister, child, close personal friend or close business associate of a founder;
        - A parent, grandparent, brother, sister or child of the spouse of a founder;
        - A person of which the majority of the voting securities are owned by, or a majority of the directors are, persons described above; and → ***Facilitates HoldCo structure***
        - A trust or estate of which all of the beneficiaries are or a majority of the trustees are persons described above

- **(d) Offering Memorandums**
    - In between a prospectus and private issuer (no information reported) – requires some disclosure about the company
    - "Eligible investors" can buy/sell securities
        - Eligible investor: individual made at least $75 000 in net income (or $125 000 with a spouse) in at least the last two years; $400 000 net asset threshold
            - **Thresholds are dropped relative to an accredited investor**
            - Accredited investors are automatically considered eligible investors
        - "**Ineligible investors" can still invest a maximum of $10 000 within a 12-month period**
        - Eligible investors can invest a max of $30 000 within a 12-month period, or up to a higher limit if they seek professional advice
    - Marketing material is incorporated into the offering memorandum – no misrepresentations in the marketing material give rise to the **same remedies as misreps in the actual OM** – damages or rescission
    - History: used to be a great way to bring in investors because of the low threshold – very very popular in AB for real estate until the 2008 recession
    - Now: must provide financial statements that are audited, and must continue with them forever, every year = people reconsidered its use = not popular
        - Audits are very expensive, especially for newer start-ups
        - Audits will be required indefinitely into the future if an issuer uses the OM exemption, so there is a corresponding indefinite increase in costs for an issuer who uses the OM exemption

- **(e) Minimum Investments**
    - Applies if an investor purchases at least $150 000 (paid in cash at the time of the trade) in the securities of a single issuer
    - **Rationale:** if making such a large investment, you would have (i) leverage and incentive to obtain relevant info from the issuer; (ii) the ability to protect yourself; and (iii) the ability to negotiate
        - No need to block these transactions/protect these people

(2) <u>Transaction Exemptions</u> – *do not require a prospectus based on the nature of the transaction*

- **(a) Business Combination and Reorganization – 2.11**
    - Exemption applies to securities issued in connection with:
        - (i) an amalgamation, merger, reorganization, POA or anything under a statutory procedure;
        - (ii) an amalgamation, merger, reorganization or arrangement that is described in an information circular and is approved by security holders; or
        - (iii) a dissolution or winding-up

- **Rationale:** investors are deemed not to need protection since they can get their money out if they want (dissenter rights apply)
    - These issuances allow outs for those who disagree with a combination or reorganization – shouldn't block these

- **(b) Asset Acquisition – 2.12**
    - Securities issued in exchange for assets having a value of at least $150 000
    - Applicable when a purchaser is paying for an asset <u>with shares</u>
    - Threshold is sufficiently high to not need statutory protection

- **(c) Other Transaction-Related Exemptions**
    - S 2.13: petroleum, natural gas and mining properties
    - S 2.14: securities for debt
        - Reporting issuer issues its own securities to creditor in order to settle a debt of that reporting issuer
        - I.e. accept shares in exchange for debt
    - S 2.15: issuer acquisition or redemption
        - If issue shares and are out of compliance, allows issuers to rebuy these shares and be back in compliance
    - S 2.16: take-over bid and issuer bid
        - Permissible to buy securities under a takeover bid without a prospectus
        - Can also pay in shares instead of cash
    - S 2.17: offer to acquire to security holder outside local jurisdiction

NOTE: ALWAYS WANT TO STAY A PRIVATE ISSUER UNDER 2.4 IF POSSIBLE

(3) <u>Trades Issued to and Among Employees, Directors, etc.</u>

Why? This legislation is favourable to employees – gives them flexibility
- From a legislative standpoint, want employees to be self-sufficient in retirement (includes former employees)
- Can trade among themselves – as long as it is voluntary and there is a fixed price mechanism established pursuant to a written agreement or formula

- **(a) Employee, executive officer, director and consultant – 2.24**
    - Shares can be issued to an employee, executive officer, director or consultant through this exemption
    - Trade must be **voluntary**
    - Permits trades to a "permitted assign"
        - Includes trustee, holding equity, RRSP or SSIF, spouse, or trustee/holding entity/RRSP/RRIF of spouse
        - Means employees, etc., don't have to hold shares directly – they can put it in a trust, transfer to a holding entity, spouse, etc.

- **(b) Trades among employees of a non-reporting issuer – 2.26**
    - Allows employees to trade amongst themselves
    - Trades must be **voluntary** – cannot require them to buy shares in any capacity
    - **ONLY works for non-reporting issuers**
    - Securities must have a **price established by a generally applicable formula** in a written agreement (such as a SHs agreement) that establishes how to value shares
    - Policy reasons:
        - Employees generally treated favourably, encouraged to invest in companies
        - Connects people
        - Allows employees to move their shares around, permitting assignments

Resale Restrictions

<u>National Instrument 45-102</u>
- Two ways for shares issued under an exemption to be resold:
    - **(1)** Selling them to someone else that fits within an exemption (can be a different exemption); OR
    - **(2)** Securities sold under a restriction – restricted period or seasoning period
        - **Restriction period** – *after which they can trade them back onto the market*
            - <u>Reporting issuer</u> (issuer already filed a prospectus): subject to a restriction period of **4 months + 1 day** from the date of distribution
                - Rationale: whatever info the investor has, have to wait 4 months – if after 4 months then can act on the info

- Non-reporting issuer: 4 months + 1 day from the later of (i) distribution date or (ii) date issuer becomes a reporting issuer – 2.5
    - Don't want to have an accredited investor buy all the shares and sell them to those who aren't accredited investors (can't do indirectly what you can't do directly)
- **Seasoning period**
    - Can be resold if the issuer has been a reporting issuer for 4 months + 1 day (plus some other requirements…not a control distribution, no unusual effort to create a market, no extra-ordinary commissions, etc.) (2.6)
    - Rationale: so you can't turn around and resell shares the day after buying them
- Resale restrictions deems a resale of securities acquired under an exemption to be a distribution

Registration (with the Securities Commission)

National Instrument 31-103

- Two components in transfers:
    - (1) Do you have an exemption?
    - (2) Who is selling you that security, and are they registered?
        - **(A) Dealers**
            - Create market by selling securities
            - "In the business" – do this frequently
            - MUST REGISTER WITH THE SC
            - Requires certain experience, training, education
        - **(B) Advisors**
            - People giving advice regarding investment portfolios
            - MUST BE REGISTERED
            - Distinct from dealers – these are giving advice (but may be some overlap)
        - **(C) Investment Fund Managers**
            - MUST BE REGISTERED
- Up until 2010 the legislation was that if you had an exemption from issuing shares = didn't need to register
    - Don't want people giving you advice to pressure you to invest
- Now: if you're in the business of dealing with securities, trying to build a market, connecting buyers and sellers, you *need to be properly registered*
    - Need certain experience and education requirements in order to be eligible
    - Want to make sure the advice you're giving is good/qualified
- Overall: note that if you have people who are brokering that they have proper registration under 31-103

COMPETITION ACT

Purpose

- To maintain and encourage competition – overseen by Competition Bureau
- The *CA* may change the terms of the deal; vendor may not be able to sell the assets (or shares) that it wants to the purchaser
    - Because of this the *CA* includes provisions for **merger pre-notifications** and **substantive reviews**
- Overall: care about big transactions that might affect competition – don't want someone to own enough of a market so no one else can compete
    - If you hit certain thresholds, have to notify the CB
    - CB has discretion to determine what they want to do
    - If the CB requires you to unwind the transaction – huge waste of money and time

Strategy for compliance

(1) File merger notification;
    a. Onerous process
(2) Request Advance Ruling Certificate (ARC) or no-action letter; OR
    a. $50 000 filing fee applies
    b. Provide limited form of notification and obtain assurance from CB that they won't challenge
(3) Request ARC *and* file merger notification

Merger Notification – Part IX of the *Act*

- **Purpose:** bring economically significant transaction to the attention of the Commissioner (to consider if the transaction would substantially lessen or prevent competition)
    - Need to notify the Commissioner if the transaction exceeds financial thresholds
    - Failure to do so is a criminal offence
- **Applicable Transaction Types (very broad):**
    - Acquisition of assets
    - Acquisition of > 20% of voting shares of a public corporation
    - Acquisition of > 35% of voting shares of a private corporation
    - Acquisition of > 50% of the voting shares where the person(s) owns more than 20% or 30%
- **Financial Thresholds - need BOTH to trigger:**
    - **(1)** all parties to the transaction (and affiliates) have assets in CND or gross revenue from sales in, from or into CDN, over $400M, AND
    - **(2)** assets in CDN being acquired or gross revenue from sales in/from CDN generated from those assets are over $96M
    - If YES to both = need to report
    - In both cases: based on the most recent year-end financial statements
- **Notification Information Requirements** – **if you have to report** - *file with the Commissioner*
    - A description of the proposed transaction and business objectives
    - Lists of any foreign antitrust authorities that have been notified (might trigger requirements in foreign countries)
    - Copies of lists of customers and suppliers for each of the products the party's supply
    - Studies, surveys, analyses and reports that were prepared or received by an officer or director for the purpose of evaluating or analysing the proposed transaction with respect to market shares, competition, competitors, markets, potential for sales, growth or expansion into new products, or geographic regions
- **Waiting Period**
    - May have an impact on the **timing of your transaction**
    - Must wait **30 days from filing date** before you can close the deal (i.e. before the money is paid)
        - Try to file ASAP
    - During the 30-day wait period, the Commissioner can request additional information and if so, the "waiting period" is **extended by 30 days** after a complete response to the request is filed
        - Once you've filed your notification, there is a 30-day waiting period where the Commissioner can request additional information
        - Upon furnishing new requested info, another 30-day period starts (happens until all questions are answered)
- **Finality of a Merger Notification Decision**
    - While parties may close a transaction after the waiting period has expired, the Commissioner is NOT required to make a decision whether to challenge the transaction during that period
    - The Commissioner can **bring an application to unwind the transaction within a year – big risk**
    - In order to provide some certainty, the CB has established some non-binding service standards:
        - **Within 14 days for non-complex transactions** (no substantive competition law issues)
        - **Within 45 days for complex transactions**
    - Note: these standards are not the law, *just a standard*

Advanced Ruling Certificates

- Prevents the Commissioner from challenging the transaction if the transaction is implemented as substantially set out in the ARC
    - "Light" version of the full notification
    - Can generally get a quicker response
    - No-action letters (issued by the Commissioner) are a step down from this:
        - Says that "we won't pursue an action for now" but doesn't rule them out from doing so in the future
        - Although rare they will take action after this
- **No need to file a pre-merger notification**
- Fee: **$50 000**
    - This fee is just the filing fee – still have to prepare the ARC, get more background, pay lawyers for all of this

Substantive Merger Review

- **Purpose:** Commissioner can make an application on the grounds that the proposed transaction **prevents or lessens competition substantially**
- **Application:** Applies EVEN IF the transaction is NOT notifiable under Part IX (e.g. assets being acquired are less than $92M)
    - Basically: even if the transaction isn't notifiable, this doesn't preclude the CB from looking into it to see whether it may impact competition
    - Often done through reporting
    - Large residual power
- **Merger analysis:** whether the merged firm would have enough market power to enable it to profitably sustain a material price increase without effective price discipline from competitors
    - If yes = deemed anti-competitive
- **Safe Harbour Thresholds**
    - Merger enforcement guidelines indicate that a merger will not likely be challenged where:
        - **(1)** The post-merger market share of the *purchaser* is less than 35% (unilateral market);
        - **(2)** The post-merger market share represented by the four largest firms is less than 65% (coordinate market); OR
        - **(3)** The post-merger market share of the *merged firm* would be less than 10% (coordinate market).
    - But in industries where firms may be able to coordinate pricing or competitive behaviour, then the safe harbour thresholds may be lower
    - Practice tip: emphasize safe harbours as much as possible, no matter how comfortable you feel in your position – help CB see that you aren't a concern

Exemptions

- Transaction in which all parties are **affiliates** of each other
- Acquisition of **real property** or **goods in ordinary course** that do not involve acquisition of all or substantially all of the assets of a business or operating segment of a business

INVESTMENT CANADA ACT

Purpose

- Review significant investments in Canada by non-Canadians (in m&a, applies where the purchaser is non-Canadian)
    - Non-Canadian: an individual, government, government agency or entity that is not Canadian
    - Canadian: an individual is "Canadian" if he or she is a Canadian citizen or a permanent resident of Canada who has been ordinarily resident for not more than one year after he or she first became eligible to apply for Canadian citizenship
    - Canadian corporation: whether a corporation is "Canadian" is more complex and requires a *determination of whether the individuals who are the ultimate controlling SHs of a corp are "Canadians", or whether certain specific deeming provisions are satisfied*

Application

- Control of a Canadian business through a purchase of assets or voting interest, the foreign acquirer may be required to either file a **(1) notice** or **(2) an application for review and approval**
    - Basically: applies where a foreigner acquires assets or shares of a Canadian business – ALWAYS APPLIES in this situation – only question is whether you have to file a notification or get it reviewed
        - Can file notice before or after the transaction, but *approval* would be required in *advance* of the transaction
    - Does not affect a lot of transactions anymore
- **Control depends on the circumstances:**
    - **(1)** Deemed control: acquisition of 50% or more of voting shares; AND
    - **(2)** Rebuttable presumption: acquisition of 1/3 or more of voting shares
        - Ministerial discretion re: cultural business or investment by a state-owner enterprise where minister has power to determine if control is acquired
        - Discretion is mostly with state-owned enterprise (usually China)

Reviewable Transactions

- Requires an application for review **prior** to the completion of the investment

- **Criteria:**
  - (1) Size of the Canadian business being acquired
  - (2) Whether it is a "direct acquisition" or "indirect acquisition" (i.e. parent company)
    - Don't want someone to circumvent the rule, have to look back and see who owns what
    - E.g. US company uses CAN subsidiary to acquire another Canadian company – need to look at who is the ultimate owner (parent company)
  - (3) Whether the investor is a WTO (World Trade Organization) investor
    - List online
  - (4) Whether the Canadian business is engaged in a "cultural business"
    - I.e. books, magazines, newspapers, film, videos, etc.
    - Will be very difficult to sell – government doesn't want Canadian content being controlled by a foreign investor

- **Financial thresholds: (exceeding the threshold makes a transaction reviewable)**
  - *Direct investment (in parent co) re: WTO investor*
    - $1.075B in enterprise value
    - $1.613B for WTO investors who are parties to certain trade agreements, and $428M for WTO investors who are state owned entities
  - *Indirect investment (in subsid) re: WTO investor*
    - Not reviewable but subject to notification
  - *Direct investment re: non-WTO investor (or WTO investor acquiring a "cultural business")*
    - $5M in asset value
    - Much lower threshold
  - *Indirect investment re: non-WTO investor (or WTO investor acquiring a "cultural business")*
    - (a) $5M if asset value of the CDN business is greater than 50% of the value of assets being acquired; or
    - (b) $50M in assets

- **Timelines:**
  - Minister has 45 days to make a determination
  - But an extension of 30 days is permitted by giving notice to the investor (and longer with consent)
  - Note: lack of control – have to get investment Canada approval, government could make a decision that the transaction should not go ahead
- **No fees** are charged to review a transaction

- **Test upon review:** whether the investment is likely to be a *"net benefit"* to Canada
  - Minister will look at the effect on Canadian *jobs*, whether the investment is a *strategic resource* (e.g. Potash Corp acquisition blocked), etc.
  - Consider: effect on economic activity in Canada, innovation, effect on competition, compatibility, technologies, will not negatively impact key resources/jobs

Notifications

- Required for all:
  - (1) New businesses commenced in Canada; AND
  - (2) For all acquisitions of control of an existing business – which are not "reviewable transactions"
- Notice can be filed before *or* within 30 days after closing
  - But the Minister has the discretion to make a "cultural business" subject to full review

National Security Interest

- The government now has the authority to review foreign investments to assess whether they are "*injurious to national security"*
  - Government has the ability to jump in and assess if there is any national security interest (2009 amendments)
- Applies to **reviewable** and **notifiable** transactions
- Timeline: Minister has 45 days to make a determination
- No fees

NON-RESIDENT VENDORS (S 115 ITA)

Canada taxes non-resident vendors on gains from dispositions of Taxable Canadian Property (TPC) (subject to some exemptions like tax treaties)

- TCP includes:
  - **Real** or **immovable property** situated in Canada
  - Includes shares or interests if more than 50% of FMV is derived from real or immovable property situated in Canada, Canadian resource property, or timber resource property during 60 months prior to sale
  - **Basically:** only have to be alert to TCP if you're dealing with real property if more than 50% of its FMV is from real or immoveable property
- Amendments in March 2010 reduce the compliance burden
  - Before these amendments it was a much broader definition
- **Process:**
  - When a non-resident disposes of TCP, the non-resident vendor is required to obtain a **certificate of compliance** from the CRA
  - Section 116 of the ITA requires a purchaser to withhold and remit a portion of the purchase price on account of the non-resident vendors' potential tax, unless a certificate of compliance is issued providing a certificate limit equal to or greater than the purchase price
  - Failure to comply can result in the purchaser being liable for tax equal to 25% (50% on certain properties) of the purchase price, minus the amount of the certified limit, if any, from the property
- **Why?**
  - Government doesn't want the seller to take the money from the sale and leave
  - So whenever the non-resident is selling taxable Canadian property, need to get this compliance certificate that requires a purchaser to withhold and remit the potential tax to be paid
  - If no certificate then the purchaser has to hold a portion for the potential tax that the vendor would have to pay
  - If no compliance – purchaser may be liable, have to pay the tax themselves potentially
- **Less applicable now because the definition was narrowed in 2010**

Unit 6: Debt Financing

Why? Two main scenarios:

(1) Don't have the money to pay the vendor the purchase price
(2) Part of a leveraged buyout
   a. Debt that is coming in to fund part of the purchase price
   b. Here the targetco borrows money

Difference: who is borrowing the money, and who has to pay it back

- Think about: where is the debt being incurred? What entity will take it on and owe it to the lender?

Debt vs equity: when a corp needs money it can issue shares, debentures, or debt
Equity: issuance of new common shares, which will dilute the SH base
Debt: borrowing money from a bank or another lender

Advantages of Debt Financing	Disadvantages of Debt Financing
- **Does not dilute ownership interest** (versus equity financing where shares are being issued) - Different from private equity firm where part of the deal is a part of the ownership capital being transferred to the party providing the funds	- **Limited availability (**lenders less likely to lend for unproven business) - Not always easy to borrow money, especially if it's a brand new company with no history, no financial statements (might need guarantee)
- **Interest payments are tax deductible** - Can borrow money and when you pay interest on the money you borrow, can use this to deduct against income on taxes	- **Regular payments (cash flow)** - While it makes forecasting better, the bank needs to get paid regularly = regular drain on cash flow - Generally the bank has to be paid first
- **Forecasting** – interest and principal payments are often fixed, allowing for accurate financial forecasting - Understand costs over time, advantage to buyer to getting more traditional lender financing	- **Collateral usually required** - Bank may also require you to maintain certain cash levels and may take security against the loan

- Security on assets, guarantees, security on shares – all collateral that the bank may use to get the loan

- **No lender claims on future earnings** – once they are paid up, they are out
- Borrowing money you know what you owe, what the interest is

- **Operating restrictions (covenants)**
- Need to be cautious - credit agreements will often impose restrictions on the borrower (e.g. any major purchases must be approved by the lender; borrower must maintain a specific debt-to-equity ratio, etc.
- Watch out for this – ask the borrower if they can still run the business they way they want with the restrictions

- **Can be secured on a short-term basis**
- I.e. bridge financing, appropriate for short-term needs
- Ask: does the client need all the money now to make an acquisition or money for the long-term?

Types of Debt Financing

Bank Financing

- **Disclosure to the lender** (including targets, projections) – can take time
    - Banks take a closer look to ensure the borrower will be able to pay back the loan – lenders do their own DD
    - Will look at financial statements, diligence on shares, assets, etc. to make sure they have the first right to it
    - Big banks are very formalistic and process oriented so can take a long time, may have a separate committee that makes decisions to lend
    - Banks are the most common lender to encounter
- **Little negotiating power** (representations, warranties, covenants)
    - Know the areas you need to make distributions without being in default, but other than that there aren't a lot of changes you can make
- **Security/collateral**
    - Lenders always look at how they can put themselves in the best position to be paid
    - If credit quality of borrower isn't enough on its own, the bank might **take security** (anything that can be pledged that the bank can take over if the borrower stops paying) or require a **personal guarantee**
        - Personal property security will need to be registered
        - Clients will need to understand the full implications of this
    - If you are buying shares, bank may take security over those shares, or the ability to take dividends

Vendor Take Back Financing

- **Vendor supports the financing** (loan or an investor in the purchaser/target)
    - More narrow type of financing
    - This is a situation where instead of a third-party loaning money to a buyer, the buyer and seller agree between them that the purchaser isn't going to pay all of the purchase price right now (can structure as an earn-out)
    - **Process:**
        - The seller pays part of it upfront, then agrees to pay part over time
        - The **vendor acts as the lender**
        - Still document the terms of the vendor take back, or can be a promissory note – this is the only real difference – instead of a bank, it's just the vendor supporting by not taking all the PP up front
    - **Key:** determining what financial measure is appropriate to use and how it will be calculated
    - **Note:** still need consideration
        - Purchase price still has to be paid – at least evidence of how it can be paid will be done at closing
        - Then document how the rest will be paid
- **Some negotiations** (representations, warranties, covenants)
    - Purchaser/borrower has some negotiation bower since they're buying from the vendor/lender
    - Alternatives can be creative – remain on until paid back, sit on board, restrictions, retain signing authority, etc.
    - Everything on the table because you're creating the transaction with just those parties
- **Security/collateral**
    - Vendor may take a security in the business they are selling, or a pledge on the shares or assets
    - Consider what it is: security over shares? Need to make sure there is a way of getting money back if they don't pay
    - *Make sure your client can be repaid, how much, what happens if payments stop*
        - Questions: can they strip cash out of the company or are they restricted? Want to have more involvement and oversight into the company because you know the business well?

Security / Priority

- **Lender takes a security interest in some or all assets** (registrations, mortgages (security over land), personal property, etc.)) of the borrower
    - Lender wants to make sure they will be repaid – needs to be enough comfort in assets or cash to make them comfortable that this will happen, which is why security interests are granted
    - Ensure the agreement is *perfected* – for the lender to be able to enforce security under the legislation, certain legal formalities have to be complied with
- **Upon default, could have assignment of IP, material contracts, etc.**
- **Pledge of shares**
    - If your deal is one to acquire shares, have a pledge of shares – formal way to grant security over shares
    - As a lender, if there is a default this allows you to have the shares transferred to your own name which gives you control (which you *may or may not want*) – then you have control, can replace directors, etc.
- **Guarantees from shareholders, etc.**
    - May need a guarantee from someone else – individual or entity with substance that is enough for the bank to sue the borrower and try to enforce on the guarantee (quicker way to get paid)
    - Lender always wants to be paid as quickly and efficiently as possible
    - This is particularly likely for *smaller* corporations
- **Postponements**
    - If SHs have lent money to the corporation, they may have registered a security interest – but other lender or the bank will want to be ranked ahead of the SH's security interest, so the bank/other lenders may require that SHs *postpone their security interest*
- **Priority**
    - If there are multiple lenders, bank may require a corporation to enter into a priority agreement with the corporation's other lenders so that the bank has priority over other parties with a security interest
    - **Debt before equity: secured debt > unsecured debt > preferred shares > common shares**
    - Can be concerning for SHs if there are multiple lenders

Unit 7: Due Diligence

- *Need to know what you're buying and its value to be able to make an informed decision*
    - Verify as much info as possible before the transaction is entered into to have the comfort to spend the money and make the deal
- *Results of DD are what drives the reps and warranties*
    - Need to know what you're asking for to put it into the agreement
- *Ensure it is clear, thorough, and well organized*

PURPOSE OF DUE DILIGENCE

Purpose: to determine/inform

- **Particular aspects of the business being acquired**
    - Deep dive into what is being acquired, so the purchaser knows what they are buying – what is the scope?
- **The value of the business or assets**
    - Determine what you should be paying for the business (valuation) – trends over time
    - Can gain an upper hand in negotiating the price as you can point to specific reasons to support your position
    - May feel more comfortable making the purchase than you otherwise would if you did not do sufficient DD
    - E.g. for real estate, get an appraisal done
- **Appropriate transaction structure (shares, asset, etc.)**
    - What approach makes sense at the end of the day?
    - Vendor: advantage of a share deal is there might be an ability to have the exemption from capital gains tax
    - Purchaser:
        - Tax diligence has to happen – does the purchaser have anything going on that would be an advantage for one structure or another?
        - The older the corp, the more skeletons in the closet so a share sale may be less attractive
- **If synergies are available**
    - Are they in complementary market? E.g. Husky & Cenovus
    - Can you gain access to a new market?
    - After the transaction how are the entities in a better position to just do it with one corp?
    - After the deal the companies still have to do business – *can't forget there are moving parts that continue*

- **Costs associated with the transaction**
- **Risks involved with the acquisition**
    - Big part of lawyer's job – identify, assess, mitigate risks involved – every transaction has risks
    - Can't uncover every problem but can assess the overall risk
    - E.g. is there ongoing litigation? Environmental liabilities? Possible IP infringements? Key employees at risk of leaving? Are consents required to transfer contracts (due to change of control provisions)?
    - *Communication with client critical* in determining risk – may be some concerns/red flags the client has
- **Terms and conditions to be included in a definitive purchase and sale agreement**
    - Can inform the types of reps and warranties that should be included – depends on what is uncovered
    - E.g. may realize that consents are required and make that a condition of closing; or may identify holdbacks in relation to litigation or key employees and there may need to be a condition that key employees sign an employment agreement

ORGANIZATION / OVERVIEW

Who performs due diligence?

- **Purchaser**
    - Amount of DD done depends on the risk the purchaser is willing to take
    - Vendor will want the purchaser to do less DD
    - Client should be involved: talk with their directors, HR (for employment issues), IT (software issues), etc.
- **Accountants**
    - Tax advice, integrating accounting reports into DD package provided to the client
    - Especially for a share sale
- **Industry experts**
    - Depending on the industry there may be a need for experts
    - E.g. mining company may need engineers and geologists, technical advisors for renewable energy deals
- **Lawyers**
    - Quarterback entire process
- **Others (seller side due diligence)**
    - Vendor should look at its own company to anticipate problems, determine its value, clean up issues, etc.
    - For internal DD, usually need people from each relevant functional area (e.g. HR, operations, systems)

Scope of due diligence

- Scope can vary significantly – depends on the type of deal
    - For share sale: usually BROAD – want to identify all risks/liabilities of the entire company that will become yours
    - For asset sale: NARROWER – focused specifically on matters relating to the asset(s) you are seeking to obtain
    - *Private equity purchaser* will want full DD whereas *strategic purchaser* may request more specific DD
- **Determine what areas of the business should be subject to due diligence**
    - **Ask:** what are the reasons the purchaser is buying the company?
        - Need equipment? Need access to certain markets? Need access to certain contracts? Others?
    - If you know what the client needs can pinpoint/frame due diligence and the kinds of issues you are going to raise as red flags
    - Could be for structure of the company, regulatory issues, key contracts, etc.
- **Thresholds: what is material – what are you going to look at?**
    - Because of the scope of the areas that can go under DD, set thresholds with client to set out the DD parameters (time or money threshold)
        - E.g. contracts above $X, or employees that make more than $X
    - *What is material will depend on the value of the deal*
        - I.e. in $500M deal probably not worries about a $10k photocopier
- **Form of reporting: what are you going to provide the client with at the end of the day?**
    - Be organized and clarify what the purchaser wants before
    - E.g. detailed report vs high level list
- **Strategies**
    - Identify risks and how to deal with them (e.g. representations, adjust price, indemnifications, etc.)
- *****ALWAYS CONSIDER THE REASONS FOR A TRANSACTION TO HELP FIND THE GAPS – what is missing?**
    - Also consider goals after acquisition:
        - Share re-org, etc.
        - Sometimes actions after acquisition may have significant effects on DD
    - Also consider the nature of the buyer – equity or strategic?

Team

- Who needs to be involved?
- How communication is coordinated

Timing

- Milestones, priorities, time restraints, etc.
- **DD can take a significant amount of time to complete**
    - Try and set some milestones to keep the process moving forwards, even if you have to move milestones due to factors beyond your control
    - Timing always depends on the deal
- **At what point can your client still have an "out" of the agreement if DD uncovers something they don't like?**
- **Account for unexpected events that can impact your timeline**
    - E.g. studies and assessments – always need an environmental assessment when purchasing a gas station, this takes time to complete
    - E.g. public registry searches
- **Factor in the client's time to review and direct further investigation**
    - May uncover additional documents you want to look at
    - Prioritizing is important – focus DD on specific areas
- **General timeline**
    - **Ask:** when can you start and for how long?
    - May start preliminary DD at the time of signing the confidentiality agreement BUT will NOT deep dive into DD process until AFTER you enter into a **letter of intent** because of the significant time and resources required
        - But *DD is normally done upfront* as part of the process of negotiating is the DD process (e.g. formulating price, reps and warranties, etc.)
        - **Normal process: confidentiality agreement – info – CIM (first piece of DD usually)**
        - Get period of exclusivity where the vendor can't talk to anyone else so purchaser can do DD – pressure to get deal done before period of exclusivity expires
    - Try to start things that take a lot of time earlier
    - May have a restricted timeline to operate in certain circumstances, e.g. competitive bids
    - Can do public registry searches at any time (info in public realm) – don't need to wait on confidentiality
        - Run at beginning and end to make sure nothing has changed
    - **Use request lists/check lists:** list of everything you want the vendor to give you
        - This starts the conversation – did anything come back? What was the answer?
        - Make sure everything is tracked, documented and accessible
    - **Post-acquisition intents:** e.g. if intention is to buy it and flip it, DD will be different
        - What's going on after the deal?
        - Purchaser – can you make a claim if you need to? What's left?
        - May need to do restructuring, make changes (can be tax driven) so diligence can flow into this
        - If a share sale company may want to clean up organizational intents, amalgamate some corps together

Reasons

- What are the reasons for completing DD?
    - Need equipment?
    - Need access to certain markets?
    - Need access to certain contracts?
    - Other?

OTHER: Data Sites

- Where the documents are located (physically or virtually) for review (i.e. contracts, financials, environmental assessments)
- **Historically: physical data sites**
    - Where all the requested documents/information are put in a specified room
    - The room in a secure location, with restricted access (sign-in sheets; list of materials created, etc)
- **Today: virtual data sites**
    - Materials are uploaded and indexed on password-protected online repository
    - Often faster, cheaper, more efficient and more secure = much more common
    - **Seller benefits**:
        - Control who has access to what documents
        - System to track activity [see who is most interested]
            - Gives vendor an idea on what is important to the purchaser(s) → can track how much time people are spending in the data room and how much time they are spending looking at certain documents

        - Useful to gauge potential purchaser's interest (especially in a competitive bid scenario)
    - Easier to set up
- **Seller disadvantages**:
    - Scanning lots of documents – might have to scan 1000s of documents
    - Software is expensive – often paid for by Vendor
    - Security risks
- **Purchaser benefits**:
    - Unlimited persons can access at same time
    - Email notifications provided when new material uploaded
    - More flexibility
    - System to track documents so you can track what you've already reviewed for own organization
- Ex: DropBox (not secure), Merrill Lynch

OTHER: DD Sources

- **Books and Records:**
    - Accounting, ledges, financial statements, audits
    - Generally, the primary source
- **Studies and Assessments:**
    - Geological reports, environmental assessments, etc
    - Note: EAs may have limited utility since it's hard to determine whether environmental contamination occurred from you or the previous owner when the nature of the business operations have not changed upon purchase/sale
- **Public Registries**
    - Ex: PPSA searches, litigation searches, etc.

Seller Side Due Diligence

- Purchaser will do the bulk of DD, but the seller should prepare for a potential sale by performing its own DD so as to ensure a smooth transaction and obtain the best price and term upon sale
    - Ensure everything is organized, complete – helps maintain confidence in the deal
    - Make info logical, easily usable and accessible, etc.
- **Process:** need to decide..
    - Who is in charge of the DD process? Who does the purchaser need to involve in the DD process? Is it necessary to keep a potential sale confidential, including from employees?
- **System to collect, index and retain**
    - Need to get a data room and organizational system ready
- **Correcting issues/defects**
    - Clean up issues proactively to streamline purchase/sale process and obtain the best price possible
- **Time commitment**
    - Can be easy to underestimate the time this will take – can be so onerous a process that the vendor doesn't have any time left to operate their business
    - Best to be proactive if possible – earlier that DD starts the better
- Ask clients:
    - What does success look like for you?
    - What is your exit strategy? E.g. 3-5 years, so make sure everything is well tracked, address defects, so when you go to sale you're in good shape and can obtain the best possible price

TYPES OF DUE DILIGENCE

Asset Sale Due Diligence

If you're doing an asset sale then the primary focus is that you're buying a BUSINESS, so need DD on the business and everything required to make it operate. Need DD on the following:

- **Assets being acquired**
    - Focus due diligence on assets you are acquiring (equipment, inventory, land, intangibles, etc.)
    - If acquiring all the assets of the business, then the process is similar to a share sale
    - Need to make sure DD is done on all assets comprised in the business so the client knows that they are buying – what they see during DD is what they get when you close the deal and pay
- **Ownership of assets being acquired (does the vendor own them free and clear?)**
    - Does the vendor own the asset fully or is there a lien/security interest on an asset?
    - Does the vendor own or lease the asset? If they lease them, you are purchasing the contract and not the actual asset

- **Transferring the assets (liens, encumbrances, consents, notice, other approvals)**
    - Are there any liens on the land or any other encumbrances/restrictions to transferring title to the assets?
    - Run searches such as the PPSA search or Bank Act search so if a security interest is registered, you can see who the secured lenders are
        - E.g. vehicles have to be individually searched
    - Whose consent is required to transfer? Any notice requirements? Any other approvals that are necessary?
- **Condition of the assets being acquired**
    - Look to the reps and warranties – usually dealt with by commercial diligence
    - May need to do an onsite inspection (depending on the industry)
    - May want reps or warranties in the agreement that specific assets are in relatively good/working condition
- **Complementary or supplementary assets needed**
    - Do you need the supply agreement? Does machine A you are acquiring require machine B to operate?
    - Do they need any further assets for this business and view this transaction as a first step?
    - Overall: need to make sure the assets the purchaser is acquiring are sufficient to continue to run the business after the deal is done
    - Benefit of purchaser – can pick and choose what assets you want, so what liabilities you acquire
- **Assumption of liabilities, obligations and/or restrictions under contract or by operation of law**
    - I.e. outstanding litigation, debts, contractual obligations (supplier contracts, employee contracts as successor employer)
    - E.g. If "buying" leased assets you will take on the obligation to make lease payments
    - E.g. employee liabilities – purchaser is taking on employment history of employees that transfer over
    - Need to know about all liabilities prior to purchase – don't want to find out about these later
- **Recourse of purchaser**
    - E.g. is asset is no good, or you assume unwanted liability, etc.
    - Consider likelihood of recovering from vendor – if acquiring all of the vendor's assets, vendor may not have anything left for you to recover from
        - May require **personal guarantees** from individual SHs; or pay some now, some later
    - If a deal is done and you have already paid, you need to claim under indemnity and sue under the reps and warranties
    - Overall: ask what is left over after the transaction is done

Share Sale Due Diligence

Be broad - more DD for a share sale because the purchaser is buying the whole business, good and bad

Remember who the vendor is:

- Asset sale: party to purchaser agreement is a corporate entity
- Share sale: vendor(s) are the shareholders, not the company, so need DD on business AND shareholders (particularly the shares that they own – can grant security interests in shares)

Need DD on the following:

- **Ownership of the shares (free and clear including, as applicable, from SH agreements)**
    - Need to look at who owns the target corporation/who owns the shares – make sure the shareholders *actually own the shares*
    - If the purchase of shares between SHs was not recorded in minute books, need to rectify this
    - Ask:
        - Is share ownership **free and clear** or are there liens or have they been pledged as security?
        - Is there a SH agreement?
        - Does anyone have options on the shares?
    - If risks must be assumed – may want to modify purchase price
    - ***Note: if there is a bank loan that has security over all your assets ("all present and after acquired personal property") then the *shares are covered by that security*
- **Other rights or interests to acquire shares – does anyone else have a right to buy these shares (i.e. options or warranties)?**
    - Stock options: gives someone the right to buy shares at a set price – so may lose shares if someone exercises option
    - Warranties: like convertible debt – vendor obtained loan and under the terms of the loan, the lender has a right to convert the debt into shares. If the lender does this, the purchaser may lose some shares
- **Transferring the shares (liens, encumbrances, consents, notices, other approvals)**
    - Have the shares been properly transferred amongst SHs?

        - Look to see if necessary director approval was obtained when the shares were transferred, or if there are other consents needed to transfer shares (e.g. change of control provision in supplier contract, or industry-specific approvals that might be needed)
    - Is there a share agreement in place?
    - Are there any other restrictions in place? ROFR?
        - Might be in a share agreement or separate agreement
    - Did you get all the shares? Make sure all are coming over
    - Ensure ability to buy shares is included (option, warrant, debt financing)
- **Adverse effects**
    - Look at the **change of control** provisions in certain contracts (i.e. key employees, customers, suppliers) to determine if a change of control could terminate the contract or would trigger requirement for additional payments
    - E.g. golden parachute – if a company is taken over by a hostile bid, an executive may have a right to large payment on change of control which could act as a deterrent to a hostile takeover
- **Nature and extent of <u>all</u> assets and liabilities**
    - Usually casting the DD net wider than you would with a share sale
    - When you buy all shares you get all attached assets and liabilities
- **Recourse of purchaser**
    - Ownership of shares in a share transaction have "fundamental reps and warranties" because the shares are fundamental to what is being bought
        - Fundamental reps and warranties: vendor makes promises with regard to ownership of shares and the existence of other rights or interests to acquire shares
    - DD will often drive what reps and warranties you have. DD can thus get tied into the actual purchase agreement
    - Think about what will be left after the deal – if buying from an individual might have a better chance of recourse

DUE DILIGENCE RESULTS

Minute Books, s 21 *ABCA* (Corporate Records)

- Minute book is usually the starting point for BOTH asset and share sales
    - More important when dealing with shares than assets, but still important to both

- **Essentially is a book of organizational documents:**
    - How the corp is formed; who has authority to enter into particular decisions; what restrictions are there on the business or transfer of shares; what transactions have been approved; all resolutions Ds and SHs have made; can look at the chronology of the company (i.e. on a particular date these were the SHs, the resolutions the company made, key decisions of the company, etc.)

- **<u>General categories</u>**
    - **Articles of incorporation and bylaws**
    - **USA**
        - Govern the relationship among shareholders
        - What happens on a sale of all or substantially all assets, what percentage of SHs must agree to a transaction, etc.
    - **Meeting minutes (physical notes) and resolutions (corporate actions voted on and signed by Ds)**
        - Look to see who signed, if everyone did sign
    - **Notice of changes in directors**
        - If there has been an amalgamation, copies of all these documents
    - **Financial statements and reports**
        - Have to file annual return – all info should be included
        - May or may not have financials if company is public
    - **Disclosures of officers and directors (s 120: material interests of directors need to go into minute book)**
        - Disclosures for potential conflicts of interest
        - Consents required to become a director

- **<u>Rationale for reviewing minute book</u>**
    - **Determine the vendor's requisite power, capacity and authority to enter into transactions**
        - Can they even sell? Is everything in place to consummate the deal?
        - May need certain parties' consents depending on the transaction
    - **Determine the capacity and authority to own property and carry-on business**
        - Rare not to have this because the company has all the powers of a natural person

        - But does come up for companies in a very regulated space – may have certain restrictions on their business
    - **Restrictions on powers**
        - Are there any restrictions on what people can and cannot do?
        - E.g. USA may limit what can be done or create different requirements?
    - **Are the shares properly issued and transferred?**
        - Need to trace chain of ownership, particularly for a share sale
            - Trace ownership from first issuance to ensure initial purchase and all repurchases were done properly and are valid
            - Make sure shares were actually paid for (by money, past performance or promissory note)
        - Sec 27 *ABCA* requires **consideration** to be paid at the time of share issuance
            - Breach could result in the CRA taking the position that the shares were never properly issued – may be tax implications
        - For asset deal: may need to have a SH resolution to approve asset deal, make sure all SHs have approved
    - **To prepare definitive purchase agreements (reps and warranties)**
        - Problems with the minute book could necessitate some indemnifications or warranties in the PSA
        - Want to know what is a risk so you can address it
    - **Legal opinions**
        - Rare to have legal opinions on commercial m&a deals in Canada (mostly on banking deals)
            - Not worth a lot because must prove that the legal opinion was negligently prepared to get any recourse
        - If you are asked to give a legal opinion, need give validity and comfort to the other side to show all the work has been done
        - Give opinion on the existence of the company, authority, capacity, etc.
        - Best option – get <u>representations</u> in the actual PSA for practical recourse

Components of Minute Book Review

All of these need to be included!

- **(1) Articles of incorporation**
    - *Is the corporation properly incorporated? This starts the company*
    - Name of corporation
        - Name may have changed over time as observed in the minute book
        - A public registry search might reference the old name, so need to be aware of any new name
        - Does it match on everything?
    - Class of shares and share attributes and rights
        - How many classes and how many shares in each class were issued
        - If you want 100%, need to know how many of each class have been issued and exactly which classes
        - Subject to a USA, if you have 51% of the shares you have control over the directors
    - **Share transfer restrictions**
        - Recall: prospectus exemptions may be included here – in order to qualify as a private issuer, one criterion is that there <u>has to be a restriction on the transfer of shares</u> – look to see if this was complied with
    - Number of directors
        - How many directors needed and how many needed to vote on resolutions
        - Whether the right number of directors ratified each resolution
        - Preferable to have range (as opposed to fixed number) to avoid having to find an immediate replacement in the event of a director dying
    - Restrictions on business
        - Avoid restrictions on business (but may be required for some professional corps)
        - Not common, but purchaser would want to know if there were any

- **(2) Organizational Resolutions**
    - *Decisions made by directors which are later confirmed by the SHs; gets the company off the ground and running*
    - Make bylaws
    - Form of security certificates
    - Issue securities (who are the shares issued to?)
    - Appoint officers, auditors
    - Make banking arrangements

- **(3) Bylaws**
  - *Rules of engagement on a day-to-day business for how it will operate from a governance perspective – know what is in bylaws and what may be missing*
  - Confirmed/approved by SHs after incorporation
  - Set out the procedures relating to election of directors
    - There are a number of related rules in the *ABCA* which the bylaws must comply with
  - Requirements for directors and SH meetings
    - Subject to articles or bylaws, a majority of directors appointed constitutes quorum (but bylaws can say otherwise)
    - Subject to bylaws, quorum of SHs = holder(s) of a majority of shares entitled to vote at the meeting (can be by proxy)
  - Officers and duties of the officers
    - CFO, CEO, etc.
  - Execution of documents
    - Will say how agreements must be executed (e.g. 2 directors needed to sign off, or CEO must sign off)
    - Are there thresholds which trigger needed approvals?
  - Bylaws related to borrowing
    - Corporation can borrow money (though allowed by *ABCA*, banks want to make sure)
  - NOTE: *ABCA* addresses some of these elements too – where there is conflict, *ABCA* is superior to bylaws

- **(4) USA (agreement between all SHs) / Shareholder Agreements (some but not necessarily all SHs)**
  - *This is where something that has been negotiated among SHs would be contained; very important as a purchaser to know if buying shares – need to make sure they are following the rules they set out for themselves*
  - There might be restrictions on asset sales: SH approval may be required to sell a specified percentage, substantially all, or all of the assets of a company
  - **Share transfer restrictions**
    - Approvals, requirements of agreement if certain percentage agree to sell, or majority agrees to sell
  - **Pre-emptive rights**
    - Rights held by existing SHs to purchase additional shares prior to shares being made available for purchase by outside parties
    - ROFR: SHs must offer shares to existing SHs before offering to sell to a third party, or rights of first offer
    - Rights to keep your percentage equivalence in case of new issuance
    - Tag-along & drag-along
      - Drag-alone provisions: contractual right to force other shareholders to sell if specified number of SHs sell
        - Can be attractive for a potential purchaser
      - Tag-along provisions: if a specified shareholder sells, other shareholder(s) get the right to sell on the same terms
  - **Regulation of election of directors**
    - USA/SA can give a shareholder control of the company by giving that shareholder the right to elect a specified number of directors
      - So even if a SH doesn't own at least 51% of shares, control of the company can still be contractually determined through a SA (could even be a 1% owner)
      - Don't need a big equity stake in a company to have control over it
  - **Management of business** (i.e. fundamental decision)
    - Select decisions that require SH approval to enact
    - **ABCA s 101:** subject to any USA, the directors shall manage or supervise the management of the business and affairs of the corporation
      - The USA may specify certain aspects of the business that directors can or cannot manage/supervise

- **(5) Share Issuance and Transfer** (share registers and certificates)
  - Make sure issued shares do not exceed authorized shares (unlikely in Canada)
    - I.e. who has been issued shares, who holds the shares, trace ownership of shares to ensure everything is complied with
    - Trace step by step to know where the shares came from and if they actually have approval
  - Transfers have proper approval
  - Consideration has been paid/received for issued shares (**s 27 ABCA**)
    - If no evidence of this, should flag
  - Transfers are not in violation of Articles / USA

- **(6) Directors**
  - Look at who the directors are
  - Disqualified persons: minors; individuals of unsound mind; bankrupt; non-humans (corps can't be directors)
    - Are directors qualified pursuant to **ABCA s 25**?
    - Must be an individual, age of minority
  - Requisite number elected pursuant to Articles
  - Vacancies must be properly filled
  - Consents to act as directors
    - **Sec 105 ABCA:** to be a director, a person must consent or be present at meeting and not refuse
  - 25% resident Canadians requirement is now removed by Bill 22
    - Previously – 25% of directors must be resident Canadians and 25% of directors who vote must be resident Canadians

- **(7) Meetings and Written Resolutions**
  - Can get some good insight looking at director resolutions (e.g. directors may have to approve major contracts, etc.)
  - Two ways that directors or shareholders can approve corporate actions: meetings or resolutions
  - Written resolutions:
    - Approval obtained by proper directors or shareholders
    - Written resolutions more common among private companies
    - **Sec 117 ABCA**: written resolution signed by all directors has the same effect as a meeting of directors
    - **Sec 141 ABCA**: same for SHs
  - Meetings – check to make sure these factors are present
    - Proper notice (need at least 21 days)
    - Can send proxies
    - Quorum & if everything was signed
    - Location – restrictions on where meetings can be located
  - Note: client will have different thresholds depending on what they want to see in resolutions – ask for the **scope and depth** of review the client wants to see (could spend a lot of money and time going through everything)

Rectifying Minute Book Deficiencies

What do you do if you find a problem (which you inevitably will)?

- Rectification involves looking back and trying to fill in the gaps where there are other things missing
- Seller may identify and remedy this during clean-up, or purchaser may point this out and request seller to deal with it

- **First step**
  - Have a list of problem that you have found – identify what is missing
  - Tell seller's lawyer what is missing (always a lot of back and forth)
  - To track – we use spreadsheets because info is constantly changing
- **Second step: confirming and ratifying resolution**
  - If step 1 is not sufficient, can use a confirming and ratifying resolution
    - E.g. the SH did not sign something and they are no longer a director, difficult to get their signature
    - Always first try to address with the other side and see if there is an easy fix
    - If all else fails, this resolution can be used to fill in the gap
  - Example: "all acts and proceedings taken until now by directors, officers and/or SHs are approved, ratified, adopted and confirmed for all purposes including the following resolutions…(financial statements, appointment of officers, issuance of transfer shares, dispensing with appointment of auditor, etc.)"
- **Other: Amendments to articles or bylaws**
  - May be acting in contravention of articles or bylaws, so need to amend them
  - Might need shareholder approval – could take time
- **LAST step: rectification order (court order)**
  - Do not want this to happen – very extreme case
  - Occurs when rectification is not sufficient to fix the error and the error is significant, OR cannot find the directors/shareholders
  - Can be very expensive
- **If things were done fraudulently – these methods will not help**

NOTE: Diligence on *partnerships*

- Common to do diligence on partnerships
- Different requirements than in the *Partnership Act*
- Might have a partnership minute book, certificate is not up to date, so may need to do another filing to make an amendment

- Be alive to issues that are purely internal that can be dealt with a ratifying resolution, versus what has a filing requirement – what approvals do we need? Different way to go about things

END PRODUCT = DILIGENCE REPORT FOR CLIENT

Public Registries

Overview

- Information available within public registries
    - Generally available info with respect to corporations, partnerships and individuals
- Typical searches and transaction specific searches
    - To determine what public searches to conduct, ask: what is the nature of the business? What matters to the purchaser?
- Nature and extent based on specific circumstances
    - When you have an understanding, you can go further – e.g. make sure IP is correctly registered, tax search to make sure taxes are paid, WCB account and any claims, etc.
    - Sometimes these searches take a long time – need to **factor in timelines –** e.g. environmental searches may take a long time because there are different phases, in COVID litigation searches are now taking a month to come back
- Subject to completeness and accuracy of input criteria
    - Remember these are public registry searches
    - Companies may not have to update their registries all the time – e.g. corp sells some shares, don't have to update – only does so on an *annual* basis, so may not be complete
    - May have a situation where it is inaccurately updated
    - Part of doing the search is to look for discrepancies and other issues

Typical Searches

- Certificate of status
- Corporate search report
- Name and status
- Bankruptcy and Insolvency Act (Canada)
- PPSA (Alberta)
- Bank Act s 427 (Canada)
- Litigation

- **(1) Certificate of status (Alberta corporations)**
    - Search this towards the beginning of a transaction, and again at the end
        - About the status of the company and if it is in good standing
        - Can be problems with companies incorporated federally – sometimes company forgets to pay the fee (don't want to find this out on closing day)
        - Affects timeline
    - **Need certificate of status for an M&A transaction – requirement for closing**
        - Need to show it is in good standing – if it has been wound up, struck, etc., then it cannot contract
        - This is a deliverable
    - Information available
        - Legal name
        - Date of establishment (date of incorporation)
        - Existence
    - Corporation type – same thing just different jurisdiction
        - Certificate of status (AB corporation)
        - Certificate of compliance (Fed corporation)
    - In AB if you fail to file an annual report = corporation will be struck
    - For a fed company, failing to file an annual report or failing to pay the requisite fee = corporation will be struck

- **(2) Corporate search report**
    - Purpose: provides some of the background info on a corporation
    - Information available
        - Current, former, predecessor names
            - Important for PPSA searches
            - Companies can change names – so need to search predecessor names

        - Registered office
            - Where the records are kept
            - Make sure this matches with minute book
        - Current directors and voting shareholders
            - Will tell you the top 5 voting shareholders (updated on an annual basis) – this is unique in AB
            - Make sure the right people are included – is this the right director? Have they been signing?
            - DON'T RELY on this list because it changes, and may have other shares that are non-voting (e.g. frozen shares or other classes not included)
    - Corporation type: established or carrying on business in AB
    - Caution
        - Only as up to date as the latest information filed (**only updated annually**)
        - If you do not file annual corporate return to update, there is about 18 months before the company is struck
        - Only accurate if the corporation has *reported* the information contained in the search
        - If there are any discrepancies between this search and the minute book, you would **need to get the corporation to certify that this information is correct**

- **(3) Name and status**
    - Purpose of searches
        - Confirm corporation exists
        - Confirm representations and warranties
            - That the company is in good standing and can transact in the jurisdiction it is transacting business
            - Could still have *liabilities* – search each prior company to make sure there are no issues
        - Corporate filings and other records up to date
        - Find other relevant names / parties to search
            - This can be the most important
            - Creates further diligence, identifies what else we need to search
- **(4) Bankruptcy and Insolvency (Canada)**
    - Purpose: confirm the corporation has the capacity to enter into and complete the transaction
        - **Prior bankruptcies could indicate rights of creditors that are still outstanding / need to be addressed**
        - This could affect your purchase strategy – will affect cash flow
    - Information available:
        - Corporation is currently or has been bankrupt
            - If bankrupt, then the corp has no power to transact – enter into transaction with the trustee
        - If there is an assignment, proposal or receiving order
    - Scope of search:
        - National – based off of information received by the National Office of the Superintendent of Bankruptcy
    - **Caution:**
        - Transmission delays may occur between when the Office receives info from the courts with respect to bankruptcy
            - I.e. company may have filed for bankruptcy but is has not yet been recorded
        - Should also do a court search if concerned about timing delays – more current results
        - Don't want to have a proceeding that was filed on a bankruptcy matter and miss it because of the delay
            - Then wouldn't have the authority to enter into a transaction

- **(5) Personal Property Securities Act (Alberta)**
    - Purpose:
        - Tells you if anyone has a registration against the personal property of the vendor / determine rights to personal property
        - Registry records the security interests in personal property
            - Helps determine whether a creditor has a security interest in assets or shares
        - Subject to certain rules, method where you perfect security to become a secured creditor and can be used to order priority
        - When a company goes bankrupt, the assets of the company are spread out to creditors, but they do not all have the same priority (secured creditors first, whatever is left to unsecured)
    - <u>What to do if there is a registration:</u>
        - The purchaser would either want to get the applicable assets **discharged** from the registry, or get a **no-interest letter** from the corresponding creditor
            - Whereby creditor asserts they no longer have any interest in the specified asset
        - If you buy shares that are subject to a security interest, that security interest will **transfer** over

        - Run search against TargetCo itself and individual shareholders too – the SHs may have taken on a loan and granted a lender a security interest in their shares
            - **Do the search at the corporate and shareholder level**
        - Condition of closing may be that the company has to pay off all debt
    - Scope of search
        - Provincial – AB
    - Types of searches
        - ***If buying shares –** want to search the name of SHs since shares could be pledged as security, and search the corporation name as well
        - Individual specific
            - May want to get DOB to narrow down
        - Individual non-specific
            - Would be a good way to start, then narrow down based on specific characteristics of the individual that you are searching
        - Business debtors
            - Searching for names of non-individual when the vendor is a corporation
            - Important to search former company names
        - Serial number of assets
            - E.g. cars, equipment
    - Who to search
        - If we're acquiring a corp = on the corp
        - If buying shares = also on the SHs to make sure no PPSA registrations against them or anything else that would prevent them from selling
    - Timing of searches
        - Allow time to discharge registrations (if needed)
        - Do PPSA searches at the beginning of the transaction since it takes time to discharge registrations or obtain a no-interest letter (if needed)
        - Search again at the end of the transaction
        - Can't always have the interest discharged, but client always has to know so agreement could be changed
    - **Caution:**
        - Encumbrances can also be created outside of the PPSA (e.g. perfecting security interest by possession, not registration)
        - Address this possibility in the purchase and sale agreement

- **(6) Bank Act s 427 (federal statute)**
    - Purpose: determine rights to assets of certain borrowers
        - Deals with loans from banks for specific industries (e.g. agriculture)
            - First to register has priority
        - Very narrow set of borrowers – system for the bank
        - Not as common, but same rationale applies as with registrations under the PPSA
    - Information available: whether a bank has taken a security interest in specific assets of certain borrowers
    - Scope: **provincial** (despite it being a fed statute)
    - Is the purchaser willing to assume? May want to adjust the terms or price

- **(7) Litigation**
    - Purpose: risk/claims to assets
        - Might not be able to settle litigation, but would want to know about it
    - Information available: whether a court action has been initiated (search QB and CA)
    - Scope: judicial district is province-wide in AB, but in other provinces may need multiple searches for each judicial district
        - Usually don't have to worry about prov court since claim limit is $25 000
        - Talk to clients about **threshold** – if doing an $85 million deal will never look at prov court
    - Questions to answer: is there is a claim, who is going to deal with it?
        - E.g. not give all the money right now and withhold until the claim is settled before full payment
    - Problem: seller does not want to lose privilege over legal documents if they are undergoing litigation, but the buyer wants to know what the claim is like
        - As purchaser need to know if you will lose any privilege to targetco
        - Targetco does not want to give away any info that could be admissible in court
    - Solution: **get a rep and warranty** from the co that there is no ongoing litigation

- **(8) Transaction-specific searches**
    - Depending on what you are buying, other searches may be applicable:
        - Trademark ownership
        - Patent ownership
        - Copyright ownership
        - Industrial designs & others
        - Domain names
        - Real estate searches
        - Labour and employment
        - Taxation
        - Environmental
        - Others
    - Always think about client needs: e.g. if buying a tech company no need for environmental searches, but if the co have underground fuel tanks this will be very important
    - About risk tolerance and the nature of the business

REMEMBER FOR SEARCHES: always depends on the type of transaction

- In asset sale:
    - Vendor is the corp
    - Here all searches are targeted at the corporation, our concern is the targetco
    - Shareholders are irrelevant – don't need to search them
- In a share sale:
    - We care about *everything* in the targetco – don't want to end up with a company with liabilities, lawsuits, etc.
    - Also need to check shares to ensure they are unencumbered
    - Very important to purchaser – don't want to buy shares and not end up with them
    - Look both to targetco AND who is vending

Contracts

- Various types of contracts and agreements should be reviewed
    - Look for **key agreements** (i.e. termination rights, restrictions, ownership)

- **Preliminary due diligence checklist**
    - Identify the transaction and the parties
    - *Request documents and information*
        - I.e. corporate records, shareholder info, corporate finance, material contracts, sales, employees, IP, inventory, litigation, tax, etc.
        - Good approach is to go broad in what you're asking for from the vendor and then narrow the scope from there (catch and release strategy)
    - Reference to all other significant documents or facts
    - If there is an auction process:
        - Information is very controlled to ensure fairness
        - But if it is a bilateral agreement then will usually have a checklist
- **Material contracts**
    - Review in light of the nature, scope and purpose of the transaction
        - What kinds of things are fundamental to the transaction?
        - Change of control provisions?
        - Want to ensure that the terms and relationships can be maintained
    - General categories
        - Purchase considerations (fundamental terms)
            - I.e. relating to key customers or suppliers, restrictions, key assets
            - What are the fundamental terms? Usually business terms – aggregate for client so they can have an overview
        - Procedural considerations
            - I.e. consents, notices, ROFR
            - Is there anything that is going to affect the contract?
            - Not on pure commercial terms, but ask what impact the transaction has on the contract and what we have to do to close
        - Negotiating and preparing transaction documents

        - I.e. representations, warranties, indemnifications
        - What do we have to do to get the transaction documents done?
- **Corporate contracts**
    - No limit to what we would really look at - these are the most common
    - Supplier
        - Economic terms are important, determination provisions, exclusivity if there are suppliers and customers (non-compete clause required?)
    - Customer
    - Leasing of personal property
        - Office, work yard?
    - General corporate nature
        - Master service agreement
        - E.g. confidentiality agreements, non-disclosure agreements
    - Excluding: lending, employment, real property, etc.
        - Lending may or may not come in
        - Employment lawyer should be brought as expert

- **Material corporate contracts – "terms and conditions"**
    - Ask upfront – what is the scope supposed to be? What does the client want to see?
    - **Parties/ date of contract**
        - Identify who are the proper parties to the contract (e.g. are there subsidiaries?
        - Was the contract signed (authorized) by both parties to ensure it was properly executed?
        - Check this first because if not signed, then the contract is *not* valid
    - **Term of agreement**
        - Is the contract *expired* or *about to expire?*
        - Check this second because if the contract has already expired = no longer good
        - If the contract will expire before closing, then renegotiate and renew the contract now to extend for a longer period
    - **Price (value)**
        - Prices and adjustments
        - Some contracts have price escalating provisions, volume discounts, and other price mechanisms (e.g. prices adjusting based on volume purchased, etc.)
    - **Overview of contract**
        - General description
        - I.e. supplier contract of product
    - **Termination/default**
        - Termination and default are different
            - Termination: for convenience, one or both parties can terminate the contract by giving required notice
                - Need to know if this exists
            - Default: usually specified events of default, notice periods
                - Need to know what the remedy is – if just breach of contract usually just damages, but need to know if there are any other available remedies
        - Standard provisions (i.e. bankruptcy, breach, etc.)
        - Unique provisions (i.e. entering into new market, using other suppliers)
            - Contact might automatically terminate if something unique happens
            - Need to know what rights the third party has to terminate the contract
    - **Assignment**
        - Can the contract be transferred/assigned?
        - What if the contract is silent on assignment?
            - **Under CL, can assign the benefit but not the obligations without consent**
            - Means all obligations go back to you if the new assignee is in breach (not favourable)
        - For asset deals assignment is especially important because it needs to be assigned as part of your deal
            - But even for share deals want to know what the assignment provisions are, if there are any notices, etc.
        - Cleanest way without express ability to assign is to get a **consent and release** – as a vendor want a release to know at the closing date that the purchaser cannot come after you
    - **Change of control clauses**
        - Transfer of control through change in ownership
        - **"Direct and indirect" change of control**

            - Can have a change of control happen indirectly if there is a holding company that controls an operating company with a contract that has a change of control provision
            - May be triggered all the way up/down the chain – have to look at the contract further down to see how a transaction that created a change of control at the top impacts below
            - E.g. change of control might affect contracts being executed by the holding co's subsidiary
    - **Restrictive covenants**
        - Non-compete
        - Non-solicitation
        - Exclusivity
        - Use/production limitations
            - E.g. may be purchasing the company to get into new markets but there may be production limits on the target company's supplier contract
        - Courts view less favourably if given to individuals rather than corporations
        - Assess time frame, geographic location, and nature of the business
            - E.g. if non-compete for an employee to work somewhere, strict interpretation
        - Difference between covenant and condition
            - Condition is something that has to happen before a subsequent event
                - E.g. reps and warranties
                - May die down the road
            - Covenant is an ongoing promise to do something
                - E.g. live obligations like non-solicits
    - **Representations and warranties**
        - Anything that would be significant if breached?
        - Have any been breached (based on DD info)?
        - What happens if breached?
        - When were they given?
    - **Obligations/indemnifications**
        - Significant obligations
            - E.g. certain quality standards, customers can inspect premises, must meet certain sales quotas
        - Indemnifications
            - What happens if the obligations are not satisfied?
            - How significant are penalties for breach?
    - **Other significant terms**
        - Contract specific, e.g. limitation of liabilities
    - **Governing law**
        - AB – if somewhere else, may need local counsel from that region
        - Good rule is to only review AB contracts

- Practical Tips:
    - Determine approach with the purchaser (client)
        - What is the scope, high level review?
    - Keep purchaser apprised of status – if you are finding big issues, need to communicate them right away
    - Keep purchaser apprised of outstanding issues/deficiencies – some issues may *change the deal* /negotiations completely
    - **<u>Due diligence memorandum</u>**
        - Set out exactly which documents have been looked at (liability reasons)
        - Summation of results at a particular date
        - Highlight key issues
        - Record of assumptions (e.g. assumed genuine signatures, no forgery, etc.)
        - Set out steps to rectify deficiencies (e.g. land contamination issues, incorrectly filed IP rights)
            - Include recommendations on how to handle deficiencies (may mean further diligence)

Unit 8: Purchase and Sale Agreement

This is the culmination of everything in the course – all other sections end up here at the end of the day

INTRODUCTION

- PSA should allocate benefits (when do benefits stop accruing to the seller and start accruing to the buyer?)
- PSA should also allocate the risk
    - Risk allocation will depend on deal specificities and market price

Structure of the Agreement

- Typical agreement is divided into a number of articles/section/clauses/paras
    - Generally, articles are the "top level" on a numbering scheme
- Common articles include:
    - Intro: Parties to the Agreement
    - Article 1: Definitions and Interpretations
        - What do the terms mean, how do we interpret the agreement?
    - Article 2: Purchased Property / Purchase Price
        - What is being purchased, how much are you being paid, how are you being paid, etc.
    - Article 3: Representations and Warranties
        - Mostly by vendor
        - Statements of fact
        - Reps and warranties basically treated the same
        - Heavily negotiated – vendor telling purchaser about themselves
    - Article 4: Pre-Closing Covenants
        - Specifies what must be done during the interim period between when a deal is signed and when it closes
    - Article 5: Closing conditions
        - Essentially conditions precedent to closing – if we don't then generally the party can walk if they choose
    - Article 6: Termination
        - What happens if the deal falls apart / a party has to get out?
    - Article 7: Post-Closing Covenants
        - Promises to do something – what happens after closing?
    - Article 8: Survival and Indemnities
        - What happens if there is a breach? Who is liable? What kind of damages and losses?
    - Article 9: General Provisions
        - E.g. document delivery addresses, who is paying the cost, what is the agreement governed under

Intro: Parties to the Agreement

- **Determine the required parties – who owns the target/assets**
    - **Share purchase:**
        - You would want the holding company as a party to the agreement
        - But the holdco might not have any assets or value besides the shares – in this case if you buy the shares and pay the holdco the money and it takes the cash, now the holdco has nothing
        - **Problem:** if there was ever a problem under the agreement and you sue the holdco **it may be liable, but you have *no recourse*** because it has **no assets**
            - Might need another party (guarantee/indemnity) so that if there is a problem you can go directly to the other person
            - Need to think who the parties are and what would happen if the agreement went wrong
    - **Asset purchase:**
        - Watch out for when all the assets are taken out of the corp
        - If you pay the money and give it to the company for the asset, it could shut down and give the money to shareholders
        - In the same situation as above – if there is an indemnity claim where you are entitled to the money, they **might not have anything**
        - Solution: add a guarantor to the PSA
            - Talk to client about when they want to add a guarantor

ON EXAM:

- **If you have a share sale the <u>vendors will be the shareholders</u> of the corp**
- **If you have an asset sale the <u>vendor is the targetco</u>**

Article 1: Definitions & Interpretations

Definitions

- Defines words and phrases in a particular way as they pertain under the agreement
- Purpose: to simplify and reduce in length (no need to define within the agreement)
- Words that have been capitalized typically indicates it has been defined
- Need to be mindful of the language used in definitions
    - "Including" suggests that it is not limited to what is stated in the definition
- Some terms may be left up to CL to define
    - E.g. wilful recklessness
- Clarity is key

Interpretations

- Improves the economy of drafting
- Example of common/key interpretations that should be included:
    - **Accounting principles to be used**
        - International Financial Recording Standards (IFRS) or Accounting Standard for Private Enterprise (ASPE)?
        - Note: these standards are challenging, sometimes need valuations, third parties, etc. – *not practical for a small company*, too onerous
        - Now we have two standards
    - **Currency**
        - CND, US, other?
    - **Gender and Number**
        - Reference to gender includes all genders and words importing the singular number include plural, and vice versa
    - **Performance**
        - Performing all things and acts on Business Days (avoid stat holidays)
        - Closing date mostly determined by whether banks are open on that date
        - How to deliver
    - **Time periods**
        - When does a period start and end?
        - Everyone needs to agree on this

Article 2: Purchased Property / Purchase Price

Purchased Property

- **What is being bought/sold?**
    - I.e. shares, assets, etc.
    - Need to know who the parties are to know what you're buying
- **What is being excluded from the sale** (if anything?)
    - "Assets to carry on business" = what you are buying
    - "Excluded assets" = what you are not buying
    - Usually not a lot of use in shares, but sometimes is possible, e.g. if someone bought the company but excluded a few assets because they were sentimental items
- **Liabilities**
    - What liabilities are being assumed / excluded (generally applies to an asset purchase)
- **Assets that require consent:**
    - What about assets being purchased that cannot be transferred at the time of "closing"?
    - I.e. might require third party consents, approvals, etc. that are not obtained at the time of closing
    - Options:
        - **(1)** Can hold assets in trust for the purchaser, but depends on the assets and the business
        - **(2)** Can specify that if the conveyance is not effected by a specified date, there will be an adjustment to the price/agreement
    - If the asset won't transfer until the consent/approval is granted, the vendor can hold it in trust until it is transferred
        - But some assets are so important that you should make sure it is transferred – do not close until consent/approval is obtained

NOTE: "sign and close" vs "sign and close later"

- "Sign and close" transaction: get everything done at the same time
  - Sign agreement/additional agreements, payment is made at the same time
  - All the conditions for the closing are satisfied (consummation of the transaction)
  - Actual legal ownership transfers from seller to purchaser
- "Sign and close later": more common
  - This is a draft agreement where purchase price etc. is agreed upon, but you don't actually close the agreement for a period of time
  - Why?
    - Seller: make sure you've got a deal
    - Purchaser: know you've got a deal, know the terms, sometimes things need to happen that you can't satisfy but want to make sure you have a deal before (e.g. getting *Competition Act* approval – won't seek this until you know you have a deal because it is so expensive)
  - Since the business is operating in ordinary course, things are constantly changing in the business
    - Sometimes might have to account for what has happened in the meantime
    - Always money coming in and money going out – makes it harder to determine a purchase price
    - Inventory – if perishables, value is changing daily
    - Try to come up with a mechanism where we can account for everything and put the parties where they want to be

Purchase Price

[1] What AMOUNT is being paid

- **(1) Fixed price**
  - Simple
    - Just write out the price
  - Easier with assets
    - Common for asset deals particularly where not all assets are being acquired
    - Typically pay fixed price + GST
  - Documentation is vital to get this right
    - If the agreement goes wrong down the line, this is what we will come back to
  - Less common because it is difficult to put a value on a business
    - More possible for an asset sale because there is usually not fluctuation of the business that might occur, just need to figure out the price of the assets

- **(2) Adjustments**
  - Essentially trying to account for the fact that things will change from agreement on price to closing
  - Approaches for calculating:
    - (i) **Working Capital (WC):** short term assets minus short term liabilities
      - Short term assets (e.g. inventory, cash) and liabilities (e.g. accounts payable) will fluctuate during the transaction – need to account for this, this involves those changes
      - Most common
      - Day to day needs to run the business
    - (ii) **Tangible Net Worth (TNW):** changes to the balance sheet (more complex than WC)
      - Net worth = all assets minus liabilities
      - Brings in different types of assets impacted by things like depreciation
  - Always consider timing:
    - Things change between the present time and closing, but also have to remember that things don't happen immediately in a company, particularly with WC
      - Always a lag when you know what really happened on daily impacts to cash
      - E.g. bills coming in, maybe recorded as payable but not actually payable, etc.
    - So when drafting these adjustments set it up while you're thinking ahead
      - When we get to closing, need to have some sort of target

  - **Mechanism for adjustments (generally) – STEPS [TIMING ON FINAL]**
    - **Step 1:** Set a target WC
      - Based on current financial position or operational needs
      - E.g. account for seasonal variation
      - Likely set out in LOI – purchase price is based on this

- Allows purchaser some certainty on the deal, gives both parties an idea of value, allows for a number (legally binding)

- **Step 2:** on closing (or shortly before) estimate whether WC or net asset value (NAV) is equal to, less or more, than the target
  - Pay the purchase price on closing plus or minus any adjustment
    - MOST FAVOURABLE FOR PURCHASER
  - If there is a difference between the target and estimate WC then need to <u>adjust the price payable on closing</u>
  - Note: the reason the price at closing is an estimate is because in order to get the actual values, you need to wait until after the fact which can take a while – thus rely on the estimate in the meantime
- **Step 3:** on post-acquisition basis, calculate whether WC or TNW is equal to, less, or greater than the amount calculated in step 2
  - If less or more this would adjust the purchase price
  - There will usually be a delay between obtaining estimated amounts at closing, and final calculated amounts post acquisition (usually between 30-90 days depending on the industry)
  - At the end of this period there is a new statement produced, then can go back and compare
    - Once it is finalized after this period, either say that the price was correct OR it was incorrect because X
    - Then credit may go back to the purchased based on how much was paid, or vice versa
  - There will generally be a <u>dispute mechanism</u> to resolve disputes over the final calculation

- **<u>Concerns with Adjustment Mechanism approach</u>**
  - **(1) Time period:**
    - Trying to figure out how long it will take for estimated numbers to become firm numbers
    - The time period to implement step 3 might be based on the nature of the business being acquired
    - Typically is 30-90 days but might need to wait an entire quarter to obtain final calculated adjustments
  - **(2) Oversight:**
    - How do you know everyone is acting in good faith?
      - *Have mechanisms to talk about and deal with how you know the calculations are being done properly*
    - Does the purchaser have oversight rights to review the WC or NAV during step 2? Does the vendor have oversight rights to review during step 3?
    - Try to get a third party to determine value of WC
    - Purchasers will usually be given a certain period of time to review the adjustment calculation, which they *are deemed to accept upon expiry*
    - During this review period parties <u>may initiate a dispute mechanism</u>
  - **(3) Disputes**
    - What is the mechanism for identifying and resolving disputes resolving calculation of WC?
      - Usually, best option is to negotiate
    - Arbitration?
      - Might be a good idea to force the auditor to choose either the vendor or the purchaser's number (and not something in the middle)
      - E.g. agree to mutual third party accounting firm to make the determination
  - **(4) Costs**
    - Who is paying for this (especially relevant with respect to the costs of disputes)
      - Negotiate for what would be best for your party
    - This process is quite accounting heavy, so need to include a comprehensive definition of what is being included/accounted for in these values to offer clarity on what is being assessed

- **<u>Earn-outs</u>**
  - Another way to adjust the purchase price, but separate from having an actual WC adjustment
    - These are more forward-looking than WC – very prospective
  - Used when the vendor thinks company the company will do very well in the future so wants a premium, and purchaser thinks the vendor's forecast is too high so wants a lower price
    - Earn out is a compromise – purchaser pays a base price and if the company does well in the next year or two, the purchaser will pay more
    - The better it does, the more the purchaser ends up paying
  - **Based on post-closing financial performance**
    - Longer period of time than the WC adjustment

- Have a defined period of time after closing where you agree to see how the business performs

- **Agreement should stipulate the following:**
  - (1) Definitive period – how long the period will be
  - (2) What metrics are being used to define financial performance
    - Can be based on profits, EBIDTA, etc.
  - No single way to structure this – just need to come up with some sort of metric to gauge the performance
  - Generally want as much *certainty* as possible to measure – need to be specific
- **Can have "caps" and "carry-forwards"**
  - Caps: cap value at which the earn out does not thereafter have to be paid
    - E.g. min profit is $1M in a year with a yearly cap of $1.5M. So earnout is up to $500K
      - If the company makes $1.8M, vendor gets $500,000. If company makes $1.4M, vendor gets $400,000
  - Carry-forwards: if you miss the target in some period but have extra in another, it balances out
    - E.g. if profit in year one is $1.1M, then in year two up to $600,000 available as earnout
- **Tax considerations**
  - Should be structured as PART OF the purchase price (NOT in addition to the purchase price) to <u>help get capital gains treatment</u>
    - Otherwise, the vendor will not be able to apply the capital gains exemption to the full amount
  - Need to draft an earn-out as a **clawback:**
    - Include the earn-out in the purchase price, then claw-back post-closing if the targets are not hit
      - E.g. purchase price is $12,500,000 being the sum of cash on closing of $10,000,000 plus the amount of the earn-out of $2,500,000
      - NOT purchase price is $10M cash on closing plus potential earn out of $2.5M
      - If we don't hit the extra $2.5M then it is just the $10M
      - Language: don't want purchase price <u>plus</u> something else – we want purchase price and then an <u>adjustment downwards</u>
    - Drawback to vendor: full amount of capital gain is realized upon closing so the vendor <u>will need to have enough cash on hand (timing issue)</u>
- **Structure an earn-out to be paid over time (generally)**
  - Can still specify that the earn-out forms part of the purchase price, but can defer payment into multiple tranches or by way of promissory note, etc.

- **<u>Vendor's concerns with earn-outs:</u>**
  - Overall: it has lost control of the target
    - Need to put in controls to keep the vendor comfortable that the purchaser will operate the company as it should
  - **(1) Risk of purchaser manipulating the values determining the earn-out** (e.g. income, profit, etc.)
    - Portion of compensation depends on performance of company no longer under its control
    - Possible that the purchaser will operate an acquired company improperly to minimize the earn-out (e.g. delay recognition of income, etc.)
    - <u>Drafting considerations to mitigate risk</u> (if representing *vendor*)
      - When calculating the metric (income, profit, EBITDA etc.) consider <u>excluding</u>:
        - Reimbursable expenses that can be invoiced directly to the client at NO cost to the Target
        - The results of any company acquired by the Purchaser;
        - Any indirect expenses allocated to the Target, including non-payroll expense, out-of-pocket supplies expense, sales and marketing expenses, administrative expenses and depreciation and amortization expenses; (i.e. if employees of the PurchasingCo are also working for the Target Co – need to make sure that the expenses correctly reflect how their time was allocated)
        - The cost of new employees hired into the Target in excess of the Business Plan (or changes the Purchaser makes in employee bonus or benefit plans, etc.)

- **(2) Risk of purchaser operating targetco improperly to avoid having to pay the earn-out**
    - Avoid this by retaining some control over the company during the earn-out period
    - Drafting considerations to protect *vendor* from loss of control:
        - Target remains under the management control of the Vender
        - Purchaser acts in good faith to continue growing the business
        - No material altering of the business, or selling of the company unless buyer agrees to continue earn out
        - Maintain the company as a separate accounting entity (don't want to mix it with another company that may be doing poorly and make it seem like the Target is doing bad)
        - Purchaser shall not redirect a material portion of Target's staff, or their time and/or responsibilities, from the management of the Target.
        - Purchaser will adjust the "earn-out threshold" if the Target loses a material customer or project as a direct result of the Transaction, or the public announcement or disclosure of the Transaction.
        - Purchaser shall not develop a business which would be competitive with Target

NOTE: if Working Capital is 0

- If WC is 0 then don't need to do the estimate, the purchaser is saying the target is 0 and there are no dollars attributed to working capital
- All WC goes to the vendor, tries to collect as much as they can
- Just means the vendors take all the cash out of the business and if it is still in on closing they don't get any value for it

[2] HOW is the purchase price being paid?

- Cash
    - Cash has a specific meaning in banking law (hard currency)
    - Raises some red flags – done either by a wire transfer or bank draft
    - Important: cheques have to clear the bank
        - Ask: does it have to be certified? Sometimes this is necessary
        - Ask: is it cleared? Are they immediately available funds?
- Seller financing
    - Secured, unsecured
    - Via vendor take-back or unsecured vendor financing
    - Promissory note (have actual payment and promise to pay)
- Third party financing
    - When money is coming in from different sources, want to minimize the number of wires that have to occur (all wires go through Toronto, take some time) – timing risk
    - Ask accounting group – what is the cut off time for wires?
        - Banks will guarantee a certain time for same day credit, but if it's after this time there is no guarantee that you will get it today
        - Bad position if you are ready to close and money doesn't land (can't close until the money lands)
    - Can also have everything sent to the vendor's lawyer in trust – can include in agreement that once the money is sent here, the deal is deemed to be "closed"
- Shares
    - But recall that a **securities exemption** must normally be utilized if issuing shares
    - Even public companies must normally file a new prospectus to issue new shares
        - But would be different if the purchaser bought their shares in the market and then used those shares to pay for the acquisition
- Must ensure there is **valid consideration** offered both ways, otherwise = no valid contract

[3] WHEN is the purchase price being paid?

- Purchase price can be "delivered" in such a way that the transaction is closed (e.g. legal title of the assets happens from vendor to purchaser)
    - Ask: what happens to the purchase price after it is closed?
- As purchaser – where is the money going? Different ways to deal with this
- **Escrow:** consideration is deposited with a third party (e.g. law firm, trust company) that then gets released once certain conditions are satisfied
- **Holdbacks:** purchaser holds back a portion of the purchase price subject to certain conditions being satisfied
    - Sometimes holdbacks will be placed in escrow

        - Ideally external third party, not law firm
    - Holdbacks do not affect the purchase price on their face
    - Why use a hold back? For adjustment to purchase price (i.e. WC adjustments), for potential damages resulting from breaches of reps, warranties and covenants, for any pending litigation
- **Reasons for escrows/holdbacks: (largely <u>protection</u> for purchaser)**
    - (1) Vendor may want a deposit against the purchase price held in escrow pending closing (not relevant to a holdback)
        - Protection for vendor – make sure the purchaser is real and will be there at closing (worried about seriousness of purchaser)
    - (2) Purchaser may want a portion of the purchase price heldback (in escrow) after closing for any adjustments to the purchase price
        - Protection for purchaser
    - (3) Purchaser may want a portion of the purchase price heldback (in escrow) after closing for damages resulting from breaches of reps, warranties and covenants
        - Protection for purchaser
    - (4) Allows for adjustments to working capital, allowance for breaches, to accommodate taxes, etc.

- **Overall: if there is a possibility the vendor has to pay the purchaser after, this is where you would think about an escrow or a holdback**
    - When on for purchaser, ask: what happens to this money after we close? What happens to vendor after close – will they still be around?
        - E.g. if share deal, gone after
        - What if there is some adjustment that has to be made after?
        - Don't wait a situation after closing where you cannot claim a remedy afterwards

Article 3: Representations & Warranties

- **Reps and warranties:** statements of fact that are said to be true at the relevant time (defines what is being paid for)
    - Note: often used interchangeably
        - Negotiations on these occur alongside due diligence
    - **Representation:** statement of fact
    - **Warranties:** promise that it is true

- **Importance for purchaser and vendor**
    - For purchaser: this is the real protection you have against things going wrong
        - Very important everything is included here if you ever want to sue
    - For vendor: this is the main part where you have a risk of being sued
        - Important that it is gone through line by line
        - Guaranteeing everything is correct, if not could be sued
- **Covenants:** promises that things are going to happen
- **Purposes:**
    - **(1) The "due diligence" purpose:** covers information about the target that the purchaser may not have been able to verify
        - Will tie into disclosure schedules
        - Remedy to buyer after closing in the event that the target (its business and assets) was not correctly described
            - I.e. an <u>allocation of risk</u> between the buyer and seller reflected to the extent of, and qualifications to, the reps and warranties
            - Provides a <u>legal remedy</u> to the purchaser after the closing of the transaction if all is not as it should be
    - **(2) The "right to walk" purpose:** provides the right to terminate the transaction or to damages, on or prior to closing, if material inaccuracies in representations and warranties are discovered before closing
        - Damages = on and after closing
        - Generally, a condition of closing will be that all reps and warranties are true and correct as of closing

Note: "come hell or high water" closings

- Have to close, but then sue after
- E.g. for public companies – if they announce to the market they're going to sign and then don't close a deal, could have a negative impact on stock price

Typical Reps and Warranties

- **[1] Corporate Matters**
  - (1) Incorporation, organization and good standing of the corporation
    - Fundamental reps and warranties like incorporation usually do not have a time period and last forever because they are so fundamental to the deal
  - (2) Enforceability: that the corporation has the authority to enter into the transaction
    - Proper approvals (fundamental)
  - (3) Confirmation that entering into the transaction would not conflict with: articles, bylaws, applicable laws or material contracts
  - **For share transactions** (may apply to asset transactions too if shares were given as consideration)
    - Capitalization: i.e. confirmation of the authorized and issued capital of the target
    - Corporate records: confirmation of the accuracy and completeness of corporate records relating to the shares
    - Residency: confirmation that vendor SHs are resident Canadians or that shares are not "taxable Canadian property"
  - These three reps will be in every deal involving a company and are fundamental
    - Everything else is an ordinary representation
    - How long a purchaser can rely on ordinary reps will depend on the agreement/purchase

- **(2) General matters relating to business**
  - Could be in a share deal or asset deal
    - Ask: what do you want protection against?
  - (1) Compliance with laws
  - (2) Authorizations and consents required
    - E.g. *Competition Act* approval
    - Think about timing, reps given during signing and closing – something may not be true at signing but will be true during closing
  - (3) No undisclosed liabilities
    - Other than ordinary course
    - Somewhat of a "catch all" designed to catch "hidden" liabilities
  - (4) Taxes: tax return filed, taxes paid or accrued
    - Share sale will have much more extensive tax reps than an asset sale
  - (5) Confirmation that there has been no **material adverse change** in the business since a benchmark date
    - Could define material adverse change (e.g. dollar threshold)
      - A common area of dispute during negotiations is determining what is "material" (how broad)
    - Could include list of specified activities that constitute "material adverse activities"
      - E.g. terminating material contracts
    - Overall: nothing is so significantly different at closing that we understand today. Be clear in definitions. Good practice to tie to when financial statements were completed. Need FULL DISCLOSURE
  - Note: if representing the *vendor*, may want to try and soften some of these reps or specify a materiality threshold

- **(3) Matters relating to assets**
  - Basically: making sure that what you're buying is enough to run the business
  - Sufficiency of the assets to enable to purchaser to carry on business in the ordinary course following closing
    - Vendor may want to push back on this type of clause without more qualification since it may not be certain that the business will be carried on the in "ordinary" way
  - Title to assets
    - Registered and beneficial owner
    - What condition they're in, that they're actually owned
  - Condition of tangible assets
    - Vendor will want to see "reasonable wear and tear included"
  - *Separate provisions dealing with particular types of property,* including:
    - Owned property
      - Will usually want environmental reps; zoning may be applicable
    - Leased real property

        - Have valid leasehold interest, not under arrears
    - Contracts
        - No knowledge of breaches; may include a list of all material contracts
    - Accounts receivable
        - Are they actually collectable? Or have they been outstanding for a period of time?
    - Inventory
        - Usable and salable – not obsolete (i.e. old technology)
        - Or saleable and expired (i.e. food products)
    - Subsidiaries
        - If share sales and other equity investments – could have separate set of reps
- Warranties about assets/revenues used to determine thresholds under the *Competition Act* and *Investment Canada Act*
    - Want reps for any act approvals
- Warranties concerning registration under the *Excise Tax Act* and for GST/HST purposes
    - Parties will want to know their respective GST numbers

- **(4) Financial Matters**
    - Confirmation of the accuracy and completeness of books and records
    - Confirmation that the financial statements present fairly the financial condition of the company
    - Confirmation that adequate financial controls are in place
    - Adequacy of working capital
    - Confirmation of "no liabilities" besides those disclosed in financial statements, purchase agreement or in ordinary course
    - If a share deal – provisions dealing with bank accounts (e.g. numbers, who the signers are, etc.)

- **(5) Particular matters relating to the business**
    - **Environmental matters**
        - Purchaser will want large guarantees, vendors want to talk them down
        - Set time limits and only commit to what you are aware of
    - **Employees**
        - Unionized and non-unionized (target may be one and the purchaser may be another)
        - If no union, need to represent this and that there have been no steps to unionize
        - May have complete list of employees and employee details (but usually redact identifying information)
        - List of employee benefit plans and pension plans
            - Especially important in asset sales because if the purchaser is wanting to bring over employees, they will want to know what is needed to entice them
        - Note: as vendor avoid providing any confidential info

    - **Employee benefit plans and pension plans:**
        - I.e. target may have very good benefit plan while purchaser does not
        - If an asset deal – relevant because you want to give employees an attractive deal or may not be willing to move
    - **Insurance**
        - That policies are adequate with regard to the business being carried on
        - If there are any outstanding claims, and what those claims are
    - **Intellectual property**
        - Who owns the IP
        - Specify any use of third party IP (any licensing agreements)
        - If there isn't any IP in the target there will usually be a rep as to that fact
    - **Outstanding litigation and proceedings**
        - Generally this will be a negative rep – this can affect the viability of the sale, especially if the value is significant
    - **Customers and suppliers**
        - Including details about their relationship
        - May list top ten customers and/or suppliers
        - Could rep that no major customers will leave on account of the transaction
    - **Taxes**
        - In share transactions this would be much more comprehensive usually
    - **Compliance with privacy legislation**
        - Becoming more of an issue – with monetary and increasingly reputational damages
    - **OVERALL:** purchasers want everything, vendors need to be very careful – time consuming process

- **(6) Qualifications**
    - Essentially how wrong you can be about your reps before you are in trouble
    - Reps and warranties are only for things that the vendor knows about
        - Standard used to assess these are based largely on an allocation of risk and negotiation power between parties
    - Knowledge
        - Define "knowledge" – is it based on actual (subjective) knowledge, or an objective standard?
            - E.g. "to the knowledge of the vendor, there is no outstanding or pending litigation"
            - E.g. "to our knowledge" or "to the vendors knowledge"
                - These are defined – who is it within the company that the knowledge is referring to?
        - Subjective:
            - If its actual knowledge, the possibility exists that someone could claim to be wilfully blind
            - We would want <u>to mandate that people make reasonable inquiries</u> (e.g. "after reasonable inquiry")
            - This is common to see regarding environmental reps
        - Objective:
            - Reasonable knowledge as to whether things are true
            - If a sole director of the company = should know everything
            - If West Jet, can't know everything (e.g. can't know everything about every employee contract)
    - Materiality/Thresholds
        - Could define materiality
            - I.e. what does "material" mean and what is a "material" contract?
            - Could mean a threshold of money (e.g. contracts worth $1000 or more)
        - Could build a materiality threshold into each applicable rep
    - Disclosure Schedules
        - Basically exceptions
            - Often after the deal the purchase agreement give reps and warranties but says "except as disclosed in schedule x" – then when you flip to that schedule there are exceptions that would make the rep untrue
        - Easier to do this than draft in the body of your agreement

<u>Purchaser Reps and Warranties</u>

- Generally very few buyer reps and warranties
- Unless consideration includes seller financing or shares of the buyer, i.e. representations that the vendor will get paid
    - E.g. financing, identity, *Competition Act* related reps
- Both parties usually interested in reps against *Competition Act*

Article 4: Pre-Closing Covenants (Positive and Negative)

- Pre-closing covenants are used to control the period between signing and closing to help ensure the completion of the transaction and preserve the value of the assets or shares being purchased (e.g. while waiting for act approval)
    - **Apply to "sign and close later" deals – if there is no intervening period, no point in including**
        - At that point you just wouldn't sign the contract
    - Closing is usually contingent on a number of things
- Typically only apply to the seller's behaviour
    - More covenants usually applicable to the vendor
        - Ask what they *have* to do between signing and closing, and what they *can* and *cannot* do
    - Vendors typically want to get away with less, purchasers usually want more from vendors
- **Purpose:** to control the seller's behaviour when the seller has committed to buying the shares/assets but have yet to close
    - **Positive covenants:** things that the seller must *continue to do* during this period
    - **Negative covenants:** things that the seller *cannot do* during this period

<u>Seller's Positive Covenants</u>

- (1) Access and investigation
    - Continue to grant the purchaser access to info for ongoing due diligence purposes or to look into operational planning
    - E.g. allow purchaser to come onto sites and take environmental samples, or talk to tenants in real estate transaction
- (2) Operation of business
    - Designed to preserve the value of the business, keep things status quo
    - Operate business in the ordinary course
    - Maintain goodwill (i.e. in asset sale need to maintain relationships with customers and suppliers)

    - Confer with buyer on material operational matters
        - Buyer will want some measure of control and insight into material matters that come up during the interim period – can say that all decisions out of the norm over certain thresholds need to seek the buyer's input
        - Work with the buyer to transition over, so buyer can take over smoothly with no interruptions
- (3) Obtain required approvals
    - Industry specific (e.g. Competition Act, Investment Canada Act, landlord consent, regulatory)
    - Don't say "best efforts" – high standard, means doing anything short of bankruptcy
    - Say "commercially reasonable efforts
- Overall: make sure value of the business is preserved to protect client

Seller's Negative Covenants

- Buyer will want a certain degree of control – seller wants to box the sale up
- Not do any of the following: *(note this is NOT a closed list)*
    - Amend constating documents
    - Issue any shares or agree to issue any shares
    - Enter into any mergers or amalgamations
    - Pay any distributions (e.g. pay out cash, give employee bonuses)
    - Sell assets out of the ordinary course or above an established limit
    - Create any new encumbrances
    - Make any capital expenditures in excess of established limits
    - Incur any indebtedness out of the ordinary course
    - Enter into, amend or terminate any material contracts
    - Enter into any joint ventures, partnerships or other arrangements outside of the ordinary course
    - Surrender, abandon or allow to expire any assets
- These covenants can be as broad or specific as you want
    - Just have to make sense in the context of the deal and parties have to agree
    - Trying to make sure you get the business the way you want it
    - Should be **tailored to the transaction**
- **Anything important to the group should be addressed**

Article 5: Closing Conditions

Closing conditions = things that must be done or satisfied before the parties will close the transaction

For "sign and close" deal: purchase agreement must be signed at the time of closing and closing occurs essentially if, as, and when the parties are ready to close (no waiting period)

- If a condition is not satisfied = deal does not close
    - It is either delayed or falls apart entirely
- Failure to satisfy the closing conditions will NOT result in legal consequences
    - Since this is done *before* the party has signed the agreement
- Closing conditions do not really apply to "sign and close" deals

For "sign and close later" deal: purchase agreement signed but with a future closing date (upon satisfaction of conditions)

- Failure to satisfy the closing conditions CAN result in legal consequences
    - Usually if one of the parties is at fault for a closing condition not being met
- Ability to maintain the deal depends on what conditions are breached
    - For certain conditions, may be able to waive them (often in exchange for a reduced purchase price)
    - But some conditions cannot be waived because they are *necessary* (e.g. regulatory approvals)
    - Note: pre-closure covenants apply only to "sign and close later"

Purchaser's Conditions to Closing

- Accuracy of representations and warranties of seller – saying everything is still true
    - A "bring down condition" – reps and warranties are true and correct as they were on day of signing
    - Often there will be a separate certificate that is signed to guarantee all reps and warranties are true, covenants have been complied with, etc. to the best knowledge
- Seller's performance of its obligations
    - E.g. seller covenants
- Consents and regulatory approvals obtained
    - E.g. *Competition Act* approval

    - Whether an approval/consent would put a closing on hold depends on the materiality of the required consent
- No proceedings to prevent closing
    - E.g. proceedings SHs or others that might not want a deal to go through
- No prohibition at law
    - Government/legal reasons why things can't happen
    - E.g. Harper government looked at selling Sask Potash Corp – ITA used to stop transaction to a bidder from China
- Financing out (i.e. conditional on financing)
    - If purchaser cannot get financing then the deal cannot go through
    - May allow a purchaser to walk away if they cannot get financing for a deal
    - Vendors want to **limit this** as much as possible – time, money, effort wasted, employees may quit in anticipation
    - As a middle point could require commitment letters to see everything ahead of time, that they have the money – banks will give commitment letters that they will give the funding subject to some conditions
- Due diligence out (i.e. date on which DD period is over)
    - Another circumstance in which the purchaser is permitted to walk away from a deal
    - Purchaser reserves the right not to close – doesn't even have to give a reason
    - Vendor wants to limit
- No material adverse event
    - Scope depends on how it is drafted
    - Could include things like wars, large drop in oil prices, etc.

Seller's Conditions to Closing

- Generally the seller's most significant condition to closing is getting **paid**
- Conditions similar to buyer's conditions to closing:
    - Accuracy of reps and warranties of buyer (brought down to closing)
    - Buyer's performance of its obligations
    - Consents and regulatory approvals obtained
    - No proceedings to prevent closing
    - No prohibition at law

Note: can have **mutual conditions** where both parties have a right to pursue a remedy if not satisfied (usually bad to have unilaterally)

- Typical with third party consents that are out of both parties' control

Article 6: Termination

- Sets out when a party can terminate the agreement and walk away – usually very specific
- Consider what your client wants and the potential reasons why the deal might fall through
- In sign and close agreements don't really need termination provisions because as soon as you sign it, its closed
- **Usually used in sign and close later purchase agreements**

Termination Events

- (1) Material breach by a party (e.g. of a positive/negative covenant)
    - If breaching reps and warranties, may have the right to walk away
- (2) Non-satisfaction of closing conditions
    - If just paying with cash = usually quite minimal reps and warranties
    - If using shares to pay = more substantial reps and warranties
- (3) Mutual consent of parties (e.g. can terminate with all parties' consent)
    - Parties can always do this
    - Don't need to include, can do this by law
- (4) Closing has not occurred before the "drop dead date"
    - Rationale: want to have a definitive ending in sight
    - Drop dead date: deal must occur by a certain date; prevents deal from dragging on
- Note: this list is *not exhaustive* – can include whatever the situation calls for (very flexible)

Effects of Termination

- Ask: does any party have an obligation? What happens on termination?
- If obligations terminated – everybody walks away
- Specific performance?
- Party in default may be liable – determine what for (e.g. break fees, penalty taxes, etc.)
- Effect depends on:

- Who terminated – was there fault (was it something the party had control over?
- Party in default is liable
  - But if the breach was by a third party neither party had control over (e.g. *Competition Act* approval), neither is liable
- Does the agreement address how to deal with termination? Grant damages against the party in default or grant specific performance

Article 7: Post-Closing Covenants

- What happens after we close? What obligations are there?
  - Remember – accounting always looks backwards, e.g. cheques might not have cleared yet
- Procedure for post-closing adjustments
  - I.e. WC/TNW: how does the procedure work and when does it happen?
  - Check to see if either party owed the other money
- Taxes and tax returns:
  - Who pays and who prepares the tax documents
  - Whenever there is a change in control of a corporation there is a *deemed year end* for tax purposes which triggers the requirement to file a new tax return
    - Important to determine which party is responsible for filing this
    - Covenants will specify who must do this
  - Want to prevent either party from manipulating
- Confidentiality / Public announcements
  - Reporting issuers (i.e. public companies) will generally have to announce any significant deal
    - Will want some provisions on how the issuer will make such public announcements
  - In the private context – may want to have rights right to be consulted before announcements made for some period of time
  - Must discuss how they will announce and what can or must be announced (keep confidentiality agreement in mind)
  - Purchaser does not want seller to be able to say anything to make sure no one finds out info about the company
- Non-compete / Non-solicit
  - Often in separate agreements with each shareholder, but can put it in the purchase agreement itself
  - Vendor may be required to introduce the purchaser to top clients
  - Make sure these agreements are *reasonable*
    - Courts generally reluctant to enforce a non-compete because they want people to be able to earn a living
    - Courts give more deference to PSAs than the non-competes in employee agreements (more level playing field)
    - Use both to lock people up
- Others
  - E.g. covenant to introduce buyer to clients, vendor to stay on in consulting role, etc.

Article 8: Survival and Indemnification

- MOST IMPORTANT PART OF THE PSA – THIS IS THE RECOURSE
  - Ask: who do you have recourse from? Who can you go after? If no deep pockets (e.g. holdco) should include the **principal** to be liable

- Survival and indemnifications all about allocations of risk
- Depends on the balance of negotiating power
- Normal period of survival is between 6 months – 2 years
- With indemnity provisions you don't have to prove foreseeability as you normally would with contractual damages
- May have certain "fundamental" reps and warranties that survive indefinitely
  - E.g. vendor actually owned the shares it said that it did

Survival of reps, warranties, covenants

- How long do reps and warranties survive?
- Length of survival period varies – all negotiable
  - Largely dependent on negotiating power of the parties
  - Typical survival period between 6 months (low end) to 2 years (high end)
- Three buckets of survival:
  - (1) **Fundamental reps**
    - Reps that **last indefinitely**

        - Generally not things that are hard to tell, e.g. number of shares outstanding, exactly what you're buying at the end of the day
    - (2) **Taxes**
        - Usually – if they're your taxes before then you pay, and if they're mine after then I pay
        - Generally survive until all tax reassessment, etc. has expired – if government doesn't assess, then they don't expire until then
    - (3) **General other reps**
        - E.g. litigation, no default under supplier contract, environmental, etc.
        - For market they survive between 12 months – 2 years (but can have some outliers either shorter or longer)
        - After this period of time whatever you do find is likely not that serious
- *The shorter the period of time, the better for the seller*
    - Expect a lot of negotiation on this point

<u>Indemnification</u>

- Ask: if the rep survives and there is a breach, who is liable and what is the procedure (notice for breach?)
- Indemnification and payment of damages by:
    - **Seller:** for breach of representations, warranties and covenants by seller
    - **Buyer:** for breach of representations, warranties and covenants by buyer
- *Minimize how much you are liable for if you are wrong*
    - If indemnification is a negligible amount, then it is not as big an issue to give more representations/warranties
- Procedure for indemnification – third party claims:
    - Option 1: Buyer pays the third-party claim and then seeks indemnification from vendor
    - Option 2: Alternatively, vendor can request to subrogate the claim (settle claim directly with third party by stepping into the shoes of the buyer
        - This option may be better for the vendor because it has more incentive to defend the successfully than the buyer who is aware that it will be indemnified after anyways
- Why allow for indemnification?
    - Without it, there is a change that the seller could only recover from the insured limited damages
- Limitations on the seller's liability:
    - **(1) Time limitations**
    - **(2) Thresholds**
        - Often included in the agreement that there be a threshold before the vendor has to make any indemnity payments (so the buyer cannot seek indemnification for minor things)
        - Two types of thresholds (parties can negotiate what they want)
            - **(1) Tipping basket**
                - If the claim is over the limit, the <u>entire amount can be indemnified</u>
                - **Preferred by buyer**
                - So if you have a bunch of small claims that all add up to the amount decided, then the entire amount is indemnifiable
                    - I.e. if $50K is the threshold, once there has been a claim of more than $50K, the claimant can go back and make a claim on <u>all</u> of the money. So could be liable here for the full $75K of the claim
                - Issue: under this approach *the buyer has an incentive to encourage more claims* so that they will get indemnification on the total value
            - **(2) Deductible**
                - If the claim is over the threshold, then get the difference (the amount in excess)
                - **Preferred by seller**
                - I.e. if the threshold is $50K and there is a claim for more than $50K, then only get the amount in excess of that
                - *Does not create the same issue as the tipping basket approach* – because the buyer will sill be required to pay out everything below the limit regardless (so will want to try to settle for less)
    - **(3) Cap on liability**
        - Usually a cap at the amount of the purchase price, or a portion of the purchase price
        - E.g. cap of $70K – if use tipping basket in above example, then liable for $70K
        - Remember three bucks – these are treated differently for caps
            - (1) Tax: usually no cap – have to pay them either way and the money is owed to the government at the time they owned the company
            - (2) Cap entirely – e.g. at 15%, so the seller can <u>never</u> be sued for more than 15% of the purchase price for all the reps and warranties they have given

        - Argue for higher or lower based on if you represent the buyer or seller – *always negotiate this*
- **All about negotiation power and allocation of risk**
    - If client is the seller and purchaser wants a higher cap, then may give that up in exchange for a shorter survival period if you think it is unlikely a huge claim will arise in the short-term
    - Depends on what the client wants and their concerns

Article 9: General Terms / Provisions

Boiler plate clauses: generally pretty standard and non-negotiable

- **Notice provisions**
    - Who do you send notice to?
    - How do you send notice? (mode of communication)
    - How long do you need to provide notice? (and when does the clock start counting?)
- **Governing law**
    - Can choose (within reasonable limitations) what law will govern
    - Generally will be the law of the parties' jurisdiction
    - If parties from different jurisdictions, may need to negotiate this
- **Entire agreement**
    - Generally highlights the parol evidence rule ("this doc is all-inclusive – only look to what is within the four corners of the agreement")
    - If it is not in the agreement then can't sue on that basis (e.g. no oral side agreement)
    - But be careful – if there is a supplemental argument that is necessary, make sure to include this as part of the PSA
- **Costs and expenses**
    - Who is paying for what, i.e. who is responsible for covering cost of lawyers, cost of joint applications?
    - Usually that each party will bear their own costs and expenses
- **Successors / Assignment / Third Parties**
    - Can you transfer the PSA?
    - Often assigned to another company before closing for tax purposes
- **Amendments: process for changing the agreement**
    - Cannot be amended unless in writing and agreed to by the parties (restating the CL)
    - Need mutual agreement, fresh consideration – normal contract law principles
- **Execution and delivery of the agreement**
    - Historically: agreement was often constituted by indenture – contract written out on ledger paper and cut into a certain pattern so they could match it up to avoid fraud or change of terms
    - Today: signatures often done electronically so the agreement may say "executed upon signature/closing & will be delivered by email/fax/scan"

***Bhasin v Hrynew* (2014 SCC)**

Good faith contractual performance is a general organizing principle in CL, and that parties to a contract are under a duty to act honestly in performance of their contractual obligations

Facts:

- B and H are competing enrollment directors working for C, which markets education savings plans to investors through enrollment directors. H had previously approached B about merging their agencies, which B refused. C appointed H to review its enrollment directors for compliance with securities laws
- B objected to having H, a competitor, review his confidential business records. C decided to give notice of non-renewal of their Agreement, and B lost the value in his business, while the majority of his sales agents were successfully solicited by H's agency.

Reasons:

- (1) C's conduct does not fit into any of the existing situations in which good faith can exist, but it is a natural extension from good faith to recognize a duty of honest performance, which "imposes as a contractual duty a minimum standard of honesty in contractual performance."

- (2) C breached its contract with B because it did not act honestly in exercising the non-renewal clause and for the purpose to merge B and H's agencies. However, all claims against H must be dismissed because H did not breach any contract and there is no liability for inducing breach of contract or unlawful means conspiracy

- General organizing principle of good faith:

    - Does not constitute a free-standing rule, the breach of which is enforceable in and of itself. Instead, it forms a standard that manifests itself in other recognized, enforceable doctrines where the law already requires candid, forthright or reasonable contractual performance
    - Parties are free to pursue their own individual economic self-interest – not to the level of a fiduciary duty
- Duty of honesty in contractual performance
    - Does not arise as a result of an implied contractual term, but rather stands as a general doctrine of contract law that imposes as a contractual duty a minimum standard of honest contractual performance. It precludes contracting parties from lying or otherwise knowingly misleading each other about matters directly linked to the performance of the contract (simple requirement not to lie or actively mislead)
    - Applies to *all* contracts – parties cannot exclude it (not negated by entire agreement clause)

Ratio:

- "It is appropriate to recognize a new common law duty that applies to all contracts as a manifestation of the **general organizing principle of good faith: a duty of honest performance, which requires the parties to be honest with each other in relation to the performance of their contractual obligations**."
- If someone is intentionally lying or misleading – it does not seem that there can be an actual meeting of the minds
- Good faith different (and less onerous) than fiduciary duty: "good faith performance does not engage duties of loyalty to the other contracting parties of a duty to put the interests of other parties first"
- Good faith "merely requires that a party not seek to undermine those interest [of the other party] in bad faith"
- This organizing principle does not create a specific duty but SCC says that there is an underlying duty that you cannot actively lie or mislead someone in the context
- There is a distinction from failing to disclose facts, but if you do tell them something you cannot lie and must tell the truth

Unit 9: Shareholder Agreements

- Govern relationships between shareholders – may have to create one in a share PSA
- **Shareholder agreement:** between two or more SHs, or between the corporation and some or all of its SHs
    - Any agreement between these parties, does not have to be unanimous/have all SHs
- **Unanimous SH agreement (USA) [*ABCA* s 1.1(ii)]**
    - A written agreement to which all SHs are, or are deemed to be, parties, whether or not any other person is a party
        - If someone has convertible debt, they often sign as well
    - If only 1 SH, cannot have a SH agreement, but can have a "written declaration" by a person who is the beneficial owner of all the issued shares of the corporation
    - *Removes or limits the powers of the board and vests them in the SHs*
        - Do this where there is a take-over by another corporation, but you do not want the other corporation's management
- In M&A context: SH agreement issues only really arise when complete control of targetco is not obtained
- Purposes:
    - The management of the business and affairs of the corporation (minority protection)
    - Issuance and transfer of shares (securities, liquidity)
    - Dealing with disputes

Management / Organization

- Power to appoint directors (see ABCA s 101)
    - Without a SH agreement, directors are appointed by SHs holding 51% or more of the shares
    - But this can be modified by a SH agreement (can allow certain minority SHs have the right to appoint directors)
- Meetings
    - E.g. locations, notices, quorum
    - SH agreement can change quorum required, e.g., or agree that unless a certain director is there quorum does not happen – to maintain control/influence/not have things done without you there
- Special SH approval for significant matters
    - Normally directors are involved in this but can be altered by USA
    - Common to alter this section for **minority protection**

        - If you don't have enough shares to vote and sway a decision, should get protection – e.g. say approval of minority SH is required for significant matters
    - Examples include:
        - Amendments to the articles or enacting or amending any bylaws
        - Issuance of new securities
        - Amalgamate, consolidate, etc.
        - Declare and pay dividends, bonuses, etc.
            - When there are several SHs at different times in their lives, they may have different views on what they prefer
            - I.e. older SHs may rely on dividends as a key source of income, vs other SHs who may prefer the money be reinvested into the corp (to increase value)
        - Borrowing funds, loans, guarantees
        - Major expenditures
- Books and records
    - Including signing authority for bank accounts
    - Can enhance rights for who can sign what
- Financial reporting
    - Format and timing of financial records, accountants, auditors, etc.
    - Can set out which things should be sent to the SHs and how regularly
- Non-Compete / Confidentiality
    - In terms of the information disclosed to SHs by virtue of the SH agreement
    - Can require SHs to keep information received confidential, cannot use the info to compete, etc.
    - Could extend the duty of loyalty beyond the time you are a SH
- Financing
    - Shareholder financing through new share purchase
    - Third party financing
    - Think about whether there are rights or protections that could be added

Issuance and Transfer of Shares

- What restrictions are put on issuing and transferring shares?
    - From DD perspective this is important to identify if there are any restrictions on transferring
- **Issuance:** often give existing SHs pre-emptive rights (offer to existing SHs on pro-rated basis)
    - These are offers from the corporation – trades between shareholders would be "transfers"
    - Rights may allow existing SHs to maintain their existing level of ownership – ensure they are not diluted out
    - May also include a ROFR – in case one SH doesn't want to buy them, the other SHs will have a right to
    - If no SHs want to buy the shares, then offer to the public or whoever is next in line – can set all of this out in USA
- **Transfers:**
    - **General rule:** no transfer of shares permitted without the consent of other SHs
        - This provision qualifies for the "restriction of transfers" for Private Issuer exemption
        - Then can pull back from here, allow some circumstances where there can be transfers, e.g. to an affiliate company
        - Permitted transferee: agreed group of parties/entities where a SH can transfer shares without consent, only need notice
    - **Other transfers: death, bankruptcy, change of control**
        - Transfers due to death, bankruptcy, change of control or other disqualifications
        - Need to consider how shares subject to each transfer would be "valued" and who is acquiring them
        - I.e. normally if you die your shares go to your estate but under a SH agreement this can be changed
            - For example: in a small corp where the SHs are also contributing members to the operation of the corp they may not want the estate to take possession of the shares, but that they redistribute them amongst themselves
        - Value of the shares: can be by agreement, through third party valuation, a pre-determined calculation, etc.
        - Issue: if representing spouses, have to think about what happens if the personal relationship breaks up, what rights they have under matrimonial property legislation
            - Don't want to deal with an ex-spouse who is upset
            - Talk about this early on with clients to decide what to do with division of property
    - **ROFO & ROFR: right of first refusal & right of first offer**
        - Need to highlight pros and cons of each to your client
        - **ROFR**

- Chance for SHs to accept an offer made to the purchaser before the purchaser can; cannot agree to sell to purchaser for a lower price than that offered to other SHs
- **Con**: more onerous for selling – may want to push back against
    - SH must find a potential buyer and negotiate with theme, and then the SH may decide to take the shares anyways (also makes it harder to find buyers willing to engage in this process)
    - *Try to get SH to say whether they will be waiving their rights beforehand*
- **Pro**: if you want out, you will still be able to get out either way
    - Likely for a reasonable price since it is what you agreed to through negotiations with a third party

▪ **ROFO**

- Offer to other SHs before a purchaser
- Can either accept the SHs offer or can find a purchaser willing to pay more, but cannot sell to a third party for less than the price offered to SHs
- **Con:** the other SHs now know that you want out (and you may be stuck waiting for a better deal)
- **Pro: less work**
- Example: before A can negotiate a deal with a third party, he must first try to sell shares to existing shareholders on whatever terms A is willing to sell. If they reach an agreement, A sells the shares to existing shareholders. If they fail, A is free to offer to a third party

o **Drag-Along / Carry-Along Rights**

▪ Seller forcing other SHs to sell to a third party

- If a certain (determined) percentage of SHs sell, the remaining SHs must sell too
- Good for the purchaser that wants total control over the targetco
- Agreement will set out the threshold that constitutes the "majority" to be able to enforce this

▪ Typically to benefit of majority SHs – prevents minority SHs from holding out on a transaction that the majority wants

▪ Usually the agreement will set out how this can be exercised and a timeline in which it must occur

▪ Generally easier to sell 100% than only part – buyer may not want to be party to a SH agreement, can come in and run the business how they want

o **Tag-Along / Coattail Rights**

▪ If one SH sells, remaining SHs can require that the purchaser purchase all or some of their shares too

▪ Allows other SHs to piggyback onto a deal – require a third-party purchaser to offer to purchase some or all of the shares of other SH(s) if it makes an offer to any SH

▪ Usually the agreement will set out how this can be exercised and a timeline within which it must be done

o **Puts / Call Options**

▪ Rights to trigger a transfer

▪ Call: right to buy at strike price

▪ Put: right to sell at strike price (force someone else to buy at x price)

▪ **Issue in private co context is determining how to set the price, so often a lot of time is spend determining how the value of the shares should be calculated**

- Need to include time periods (time to respond, etc.)

▪ This is a way for minority shareholders to get some kind of **liquidity** for their shares

- Can be hard to sell a small percentage of shares regardless of how much it is worth

NOTE: all of these are very important for DD – client needs to know

Disputes

- General: disagreement between or among parties are dealt with in a particular manner / process
    - Need to talk to client about this ahead of time
    - Ask: what to do if things go badly
- Manners to deal with disputes:
    - Arbitration
        - Costs – can be very expensive
        - Can make sure the cost of this is split
    - Litigation
    - Negotiate an agreement
        - This is usually ideal, better for both parties and less expensive
        - Make sure to have provisions that allow time for negotiations

- **Shot gun / buy sell**
  - Enables the removal of one of the SHs (way of resolving irreparable disputes)
  - Process:
    - (a) an offer to purchase the shares of the other SH(s) on certain terms; or
    - (b) if such offer is not accepted, the offered SH must purchase the shares of the offering SH on the same terms
    - Forces a buy/sell
  - Risks / considerations when deciding whether or not to include a shot gun clause:
    - The power balance/expertise between the two shareholders:
      - If the SHs were the founders of the corp (e.g. one is financier, one is operator), over time the corp will likely become less dependent on the financing and the operator becomes less value
      - This may lead to a situation where the operator triggers the shot gun clause and lowballs the financier
      - BUT if you have two (or more) SHs that are equal then a shot gun clause is a more logical option
    - Available funding:
      - Want to make sure that your client has the money or access to the funding in the event that you or the other party pulls the shot gun
      - The other SH may take advantage of you if they know you will not be able to pay
    - Can be challenging with more than two SHs – can get messy with drafting

Unanimous Shareholder Agreements – ABCA s 146

- **146(1)** A unanimous shareholder agreement may provide for any or all of the following:
  - (a) the regulation of the rights and liabilities of the shareholders, as shareholders…;
  - (b) the regulation of the election of directors;
  - (c) the management of the business and affairs of the corporation, including the restriction or abrogation, in whole or in part, of the powers of the directors;
  - (d) any other matter that may be contained in a unanimous shareholder agreement pursuant to any other provision of this Act
    - NOTE: Since you want to be under this if making a SA, you will typically see specific mention of this section

- **146(2)** If a unanimous shareholder agreement is in effect at the time a share is issued by a corporation to a person other than an existing shareholder,
  - (a) that person is deemed to be a party to the agreement whether or not the person had actual knowledge of it when the share certificate was issued,
  - (b) the issue of the share certificate does not operate to terminate the agreement, and
  - (c) if that person is a bona fide purchaser **without actual knowledge** of the unanimous shareholder agreement, that person **may rescind** the contract under which the shares were acquired by giving a notice to that effect to the corporation within a reasonable time after the person receives actual knowledge of the unanimous shareholder agreement.
    - NOTE: This gives a limited period of time where you can rescind investment if the buyer GENUINELY didn't know of the USA
      - If there is a USA under the Act and a SH buys shares, they are deemed to be a party **whether or not they knew it was in place**
      - Gives them the OPTION to rescind—do not have to
      - But must establish you really didn't know of the USA
      - Then company issuing shares gets them back
    - This can be an issue when the company is issuing shares to **employees**
      - Because there is a USA every employee would become a party
      - Problems with getting things signed, consents required, problems when employees leave
      - Should avoid clients issuing shares to employees when there is a USA in place – have a normal SH agreement and maybe their own class of shares to prevent problems

- **146 (3)** If a unanimous shareholder agreement is in effect when a person who is not a party to the agreement acquires a share of a corporation, other than under subsection (2),
  - (a) the person who acquired the share is deemed to be a party to the agreement whether or not the person had actual knowledge of it when the person acquired the share, and
  - (b) neither the acquisition of the share nor the registration of that person as a shareholder operates to terminate the agreement.
    - NOTE: If third party didn't know about the agreement

- USA applies to every party, period
- Not knowing that a USA was in place can let anyone reading for the first time rescind

- **146 (4)** If
  - (a) a person referred to in subsection (3) is a protected purchaser as defined in the Securities Transfer Act and **did not have actual knowledge** of the unanimous shareholder agreement, and
  - (b) the person's transferor's **share certificate did not contain a reference to the unanimous shareholder agreement,**
  - that person may, within 30 days after the person acquires actual knowledge of the existence of the agreement, send to the corporation a **notice of objection** to the agreement.
    - NOTE: this is the remedy component
      - Send notice to have the corp buy back the shares for FMV

- **146 (5)** If a person sends a notice of objection under subsection (4),
  - (a) the person is **entitled to be paid by the corporation the fair value of the shares held by the person**, determined as of the close of business on the day on which the person became a shareholder, and
  - (b) section 191(4) and (6) to (20) apply, with the necessary changes, as if the notice of objection under subsection (4) were a written objection sent to the corporation under section 191(5).
    - NOTE: If one of the shareholders backs off and exercises their right because they didn't know about the USA, then the corp must buy them out.
      - Valuation functions like dissenter rights, is assigned by courts
      - Trying to put the parties back in the situation they were in before

- **146 (6)** A transferee who is entitled to be paid the fair value of the transferee's shares under subsection (5) also has the right to recover from the transferor by action **the amount by which the value of the consideration paid for the transferee's shares exceeds the fair value of those shares.**
  - NOTE: This equalizes the shareholders who have rescinded—allows them to get fully refunded even if above and beyond FMV.
    - Corps will want to make sure potential buyers are aware of the USA and have seen it so they cannot blindside the corp.
    - Will typically get buyers to sign onto the USA which guarantees they have seen it.
    - Responsibility and onus is on corp as they have obligation to pay out

- **146 (7)** A shareholder who is a party or is deemed to be a party to a unanimous shareholder agreement has all the rights, powers and duties and incurs all the liabilities of a director of the corporation to which the agreement relates to the extent that the agreement restricts the powers of the directors to manage the business and affairs of the corporation, and the directors are thereby relieved of their duties and liabilities, including any liabilities under section 119 or any other enactment, to the same extent.
  - NOTE: Directors can have certain powers taken away
    - So there are things that directors do not have control over in these cases.
    - Whoever takes powers away from directors also assumes attached liability. Directors don't get a raw deal by having powers taken away, as they would if they lost the powers but retained the liabilities.
    - Courts will arguably still likely arrive at this position without relying on this provision based on equitable principles
  - Can help by pulling decisions away from the directors and putting them into the hands of SHs – protect individuals from exposure to liability
    - But if you do this under a USA, everything comes back to the SHs and are their liabilities
    - In a corporate setting this may be preferable – think about who the client is, who are the SHs, what protections are in place

- **146 (8)** A unanimous shareholder agreement may not be amended without the written consent of all those who are shareholders at the effective date of the amendment.
  - NOTE: Amendments to USA's require written consent of all shareholders
    - **THIS IS PARTICULAR TO AB**
      - In Ontario, for example, SA can give the right to a single individual or a group, or a majority to amend whenever.
      - But this can be inconvenient when you have a lot of shareholders.
    - **Only way out of this rule is s 146(9)**

- **146 (9)** A unanimous shareholder agreement may exclude the application to the agreement of all but not part of this section.
    - NOTE: Only out from s 146(8)—allows shareholders to elect to not have that section apply.
        - You have to exclude the application of the ENTIRETY of s 146 to get out of s 146(8).
            - Which creates a lot of knock on effects
        - You are either IN s146, or you are out.
            - STATE THIS IN YOUR SHAREHOLDER AGREEMENT EXPLICITLY
            - Big benefit to s 146 is the deeming component. Cannot contractually create a deeming rule
            - But nobody relies exclusively on s 146 - sophisticated parties will always check USA's/SA's. This really operates where things get missed, or people try to not involve lawyers/do it themselves.

NOTE: What happens when a shareholder agreement excludes 146?

- Even if it's between all shareholders, it isn't a "unanimous shareholders agreement"
- Excluding s 146 means you *do not have the ability to transfer power from directors*
    - Since directors' powers are only granted subject to explicitly s 146, not "shareholder agreements" in general
- *Cannot force the agreement on subsequent shareholders*
    - Since that is a power granted by s 146
- You'll just have an agreement that just so happens to be between all the shareholders, not a USA