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GUIDE TO DOING BUSINESS IN CANADA: MERGERS & ACQUISITIONS

Mergers & acquisitions (M&A)

Canada is an ideal location in which to establish and grow a business. One of the most common ways for foreign companies to expand to the Canadian market is through a merger with or acquisition of an existing Canadian business. There are a number of advantages to choosing Canada:

- It has strong international trade arrangements and ties.
- Businesses operating in Canada have access to a large market across North America due to the North American Free Trade Agreement (NAFTA) (and, once ratified, its successor, the United States-Mexico-Canada Agreement (USMCA)).
- Canadian banks and financial institutions are open to financing investment and expansion, and are frequently ranked as the soundest financial institutions in the world.
- Canada's business operating costs have historically been the lowest in the G-7.
- Canada has one of the world's most attractive tax regimes.

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1. Planning a private M&A transaction

a. Structuring of M&A for a private Canadian company
There are two common forms used to structure mergers and acquisitions of private businesses in Canada: share purchase transactions and asset purchase transactions.

In a share purchase transaction, the buyer purchases all (or a majority of) the issued and outstanding shares of the target corporation from its shareholders. An asset sale involves the negotiated purchase of the assets (and in many cases the assumption of certain liabilities) of a company without acquiring the entity that owns them. An asset purchase transaction is typical when only a single property or division is of interest, or the new owner wishes to cap legacy liability exposure.

Depending on the circumstances, other more complicated merger and acquisition methods might be used. For example, if the target has a large number of shareholders or option holders, an amalgamation or arrangement under the relevant corporate statute might be the best method of completing the acquisition. An amalgamation typically involves the merger of the acquiring corporation (or a subsidiary) with the target corporation. A plan of arrangement is a flexible process permitting transfers of property, amendment of articles, and share exchanges or other dealings with the rights and interests of the shareholders provided that the approval of shareholders (and in some cases the holders of other securities) and court approval have been obtained. Another possible form is a hybrid transaction where the seller receives the benefits of selling shares and the buyer receives the benefits of buying assets. For example, you may be able to structure the transaction so that the buyer benefits from a step-up in the cost base of tax depreciable assets while the seller still maximizes its after tax cash proceeds from the transaction.

The choice of form to be used in any given instance is a threshold issue that is determined through negotiation between a buyer and seller and typically involves significant input from the parties' tax advisers.

For tax reasons, buyers generally prefer asset transactions (unless the buyer is specifically looking to acquire certain tax attributes of the target), while sellers generally prefer share transactions. The parties also need to consider that asset transactions are generally more complex than share transactions since they require parties to obtain a larger number of consents and to transfer a larger number of diverse assets. However, asset transactions may be the only practical structure when the parties want to transfer some (but not all) of the assets of a business. Further, the additional due diligence required for a share transaction may impose longer pre-acquisition time frames.

**b. Due diligence**

Due diligence is the process undertaken by the buyer to familiarize itself with the business and assets of the seller or target. The scope of the due diligence generally varies depending on the nature of the business being acquired, the industry in which the business operates, and other legal and business considerations. In addition, the nature of the due diligence is dictated by the structure of the acquisition.

In a share transaction, legal due diligence typically involves:

- A review of the corporate records of the target corporation (as described in more detail below);
- A review of any contract or agreement to which the target corporation is a party;
- Public searches in connection with corporate status, encumbrances and litigation;
• A review of the target corporation’s intellectual property;
• A review of certain governmental records regarding the target corporation that can only be accessed with the target corporation's written consent (related, for example, to tax, employment or the environment); and
• Other diligence as dictated by the nature of the target corporation's business.

Corporate records should be reviewed to verify the number and type of issued shares of the target corporation. A review of these records (particularly the board of directors’ minutes) may also provide valuable insight into the target corporation's business, and may help uncover potential liabilities that can be addressed prior to the closing of the acquisition.

Legal due diligence in an asset transaction is generally the same, though focused on matters that are related to the assets or liabilities being acquired/assumed.

Non-legal due diligence, which focuses on financial, operational, management, administrative and tax/accounting matters, is also generally undertaken in all acquisitions.

2. Regulatory approvals

a. Investment Canada Act and Competition Act

Acquisitions or investments that exceed certain thresholds are subject to review under the Investment Canada Act and pre-notification under the Competition Act - see the "Regulation of foreign investment" chapter for further details. Canadian M&A is generally based on "free market" principles, with minimal regulatory involvement.

3. Tax matters

Acquisition vehicle and the use of a Canadian subsidiary

Typically, a non-Canadian buyer will incorporate a Canadian subsidiary to act as the acquisition vehicle. The use of a Canadian subsidiary serves a number of business purposes, including insulating the buyer from the activities of the seller/target, and offers incidental tax advantages.

These tax advantages may include:
• Facilitating the deduction of interest on financing for the acquisition against the income of the Canadian target;
• Creating high paid-up capital in the shares of the Canadian subsidiary to facilitate repatriation of funds back to the non-Canadian parent corporation free of Canadian withholding tax; and
• Positioning the buyer for a possible "bump" in the tax cost of the Canadian target's non-depreciable capital property
To take advantage of some of these benefits, it may be necessary to carry out a subsequent amalgamation of the acquisition vehicle and Canadian target. Care is required in designing the share structure of the Canadian subsidiary and arranging for it to be properly capitalized and financed for the acquisition, especially in light of the Canadian “foreign affiliate dumping rules.” Where assets, rather than shares, are being acquired, it is even more important to consider using a Canadian subsidiary. If the non-Canadian buyer purchases Canadian business assets and carries on the business directly, it will be liable for debts and liabilities which it incurs in carrying on the business operations. It will also be liable for Canadian tax on the income from those assets and any business carried out in Canada, and will have to file Canadian income tax returns every year, reporting its income from Canadian operations. By using a Canadian subsidiary to acquire the assets and to conduct the Canadian operations, the subsidiary becomes responsible for reporting the income and paying tax on the income, instead of the non-Canadian parent.

4. Employment and labour matters

a. Buyer's obligations toward employees in a non-unionized workplace

A buyer of shares steps into the shoes of the employer. All employer obligations continue to be borne by the target corporation and all employment terms remain in existence at closing. Thus, all obligations (both to existing and ex-employees) remain with the business acquired - except to the extent assumed and satisfied by the seller pursuant to the purchase agreement. Typically, indemnity provisions will be negotiated between the seller and buyer, but the target still remains on the hook to satisfy all obligations to existing and ex-employees.

Subject to statutory successor employer rules, the buyer of assets does not inherit pre-closing obligations - except to the extent assumed by the buyer pursuant to the purchase agreement, or if in Québec. The buyer is on the hook for all obligations arising from the date of re-hiring. Again, negotiated indemnity provisions may reduce the buyer's exposure under statutory successor employer obligations, but the buyer still remains on the hook to satisfy those obligations to re-hired employees. In Québec, the buyer of assets inherits most pre-closing obligations. For further details about successor employer rules, see the "Re-employment" section.

b. Obligations of a buyer of assets versus a buyer of shares in a non-unionized workplace

A buyer of assets (except in Québec and subject to any contrary obligations in the purchase agreement):

- Is free to "cherry pick" which employees, if any, will be offered employment with the buyer;
- Is not required to match pre-closing terms of employment (subject always to compliance with statutory requirements); and
- Will not have any obligations toward employees who are not offered or do not accept employment with the buyer.
A buyer of shares inherits a target with all employees, all existing terms of employment and all obligations on closing (except in Québec and subject to any contrary provisions in the purchase agreement). A share purchase does not, in itself, change (or give the buyer or target any right to change) employment status or employment terms.

c. Re-employment

For statutory purposes, generally a buyer cannot simply re-employ the employees and ignore the employees’ service history with the acquired business. However, for other purposes including common law reasonable notice, a buyer may be able to do so (except in Québec). Technically (again, except in Québec) a buyer is not obliged to recognize prior service for non-statutory purposes (e.g., when considering eligibility for stock option awards or under internal severance policies).

At the federal and provincial levels, for both unionized and non-unionized workplaces, statutory “successor employer” provisions ensure that for statutory purposes the sale of a business (whether via share or asset purchase) does not interrupt employment for employees of the acquired business who are employed by the buyer after closing. Some exceptions apply, such as when there is a prolonged break in service between the last day of employment with the acquired business and the first day of employment with the buyer (Ontario, for example, requires at least a 13-week period of non-employment to “break the chain”). In the absence of a sufficient break in service, terminating employment at or before closing and then re-hiring after closing will not suffice to “break the chain” of service for statutory purposes.

In a non-unionized environment, if the buyer wants to “break the chain” for non-statutory purposes, the buyer must include enforceable written provisions in an employment agreement or hiring letter, clearly specifying that prior service will not be recognized except to the minimum extent required by applicable employment or labour standards legislation.

In Québec, the Civil Code and labour standards legislation generally prohibit a buyer of assets from re-employing the employees as new employees without recognizing their seniority with the acquired business for all purposes.

d. Employment agreements or outstanding claims

Typically, termination or severance and change of control obligations are embedded within employment agreements or hiring letters. A clear understanding of all termination or severance-related obligations is critical.

Because of the "reasonable notice" concept (for further information, see the "Employment law" chapter) these obligations are often much more significant than they might first appear.

A buyer should carefully review all termination or severance-related provisions (and potential enforceability risks) under all employment agreements, hiring letters, variable compensation or incentive plans (cash-based and equity-based), and policies. Note whether change of control provisions or agreements are "single trigger" (triggered by closing, regardless of re-employment) or "double-trigger" (triggered only if the employee is not re-hired, or is terminated at or within a specified period after closing).

A buyer should also pay attention to pending lawsuits, outstanding employee complaints, government investigations and recent terminations (unless a release agreement has been executed by the ex-employee).

e. Changing terms of employment
As noted previously, a buyer of assets has significant control over terms of employment at the point of re-hiring (except in Québec). Ideally, such changes will be implemented through pre-hiring employment agreements or hiring letters effective on closing. However, a buyer of shares does not have any automatic right to alter terms of employment after closing.

In a non-unionized workplace, in order to change terms of employment post-closing, the buyer must follow proper notification processes or negotiate the revised terms directly with each individual employee.

If changes affect essential terms of employment and are disadvantageous to an employee (for example, a 15 per cent salary reduction) the buyer may face a claim from an objecting employee, referred to as a "constructive dismissal", that the employer has breached the contract of employment. Even if the employee does not object, if a dispute later arises, certain changes may be unenforceable unless "fresh consideration (value)" is provided to the employee (for example, a modest signing bonus or stock option grant). Mere continuation of employment is not sufficient "fresh consideration."

**f. Pensions and benefits**

Existing pension and benefit entitlements must be addressed if shares of the target corporation are acquired or, in the context of an asset purchase, if there is a collective agreement or employment agreements that require such pensions and other benefits to be provided. The manner in which these pension and benefit entitlements are addressed depends on the specific facts and circumstances of the transaction, and of the parties involved. A buyer should consult with its advisers at an early stage to consider these matters.

**5. Distressed M&A**

The buyer of a seriously financially distressed business in Canada faces many of the same challenges that would be presented in the U.S. or other jurisdictions. If the target is insolvent or "in the zone" of insolvency, time is critical in preserving, as best one can, enterprise value. Ideally, as a buyer of a distressed business, you want to gain the maximum leverage in controlling the speed and trajectory of the sale process. However, exercising such control in a Canadian court-supervised process is inherently problematic since the court will always prefer to expose the target to the largest market for the longest time possible in the circumstances.

The use of "toe hold" distressed lending or investing can provide an initial advantage to give the buyer the opportunity to become familiar with and receptive to the target's management and stakeholders, in order to gain access to valuable due diligence on the target and to participate in the formulation of the sale process. Agreeing to be the "stalking horse bidder" may also permit a buyer to participate in the formulation of the subsequent competitive sale process from a structural and timing perspective, and to set a price floor and a modest break fee.

The use of credit bidding in a Canadian court-supervised sale process (whether in reorganization or receivership proceedings) continues to grow. Canadian court supervised sale processes in many instances have adopted the standard features of the U.S. sale process (e.g., with a competitive or auction model being utilized). It is important to note that Canadian courts have only recognized credit bidding in circumstances where assets being sold were fully charged by the security underlying the credit bid. Equally, the credit bid process should not be used as a foreclosure process and for that reason it will likely only be used within the context of a competitive sale process.
Doing business in Canada - a checklist

Is Canadian business in your organization's future? Our checklist offers a high-level summary of the legal issues organizations should consider before entering the lucrative Canadian market.
Doing Business in Canada: Top ten things that may surprise you

Although Canada's legal system may be familiar to many foreign investors and companies, it has a number of unique aspects that may surprise you.

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