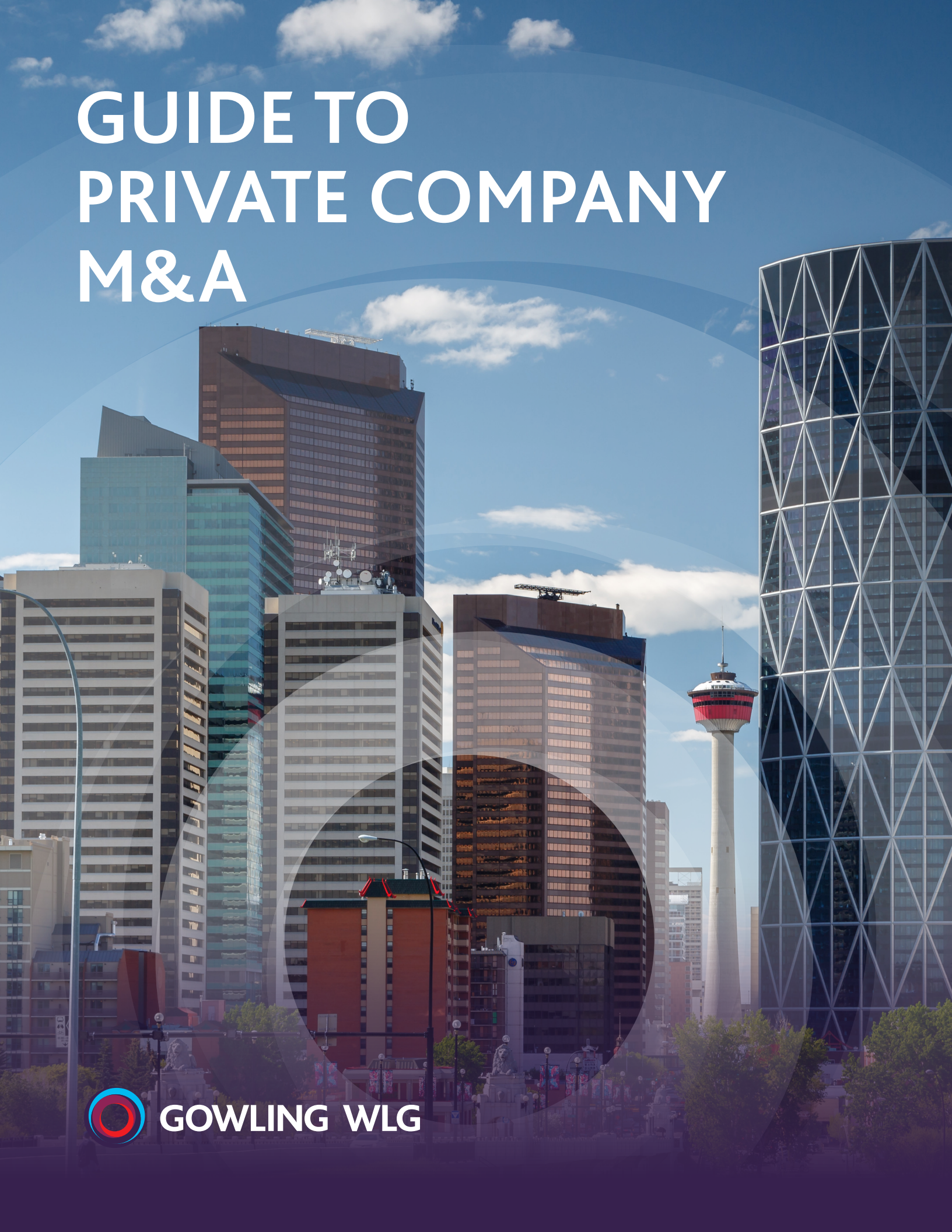
GUIDE TO PRIVATE COMPANY M&A



GOWLING WLG

CONTENTS

Introduction 6

Frequently Asked Questions (FAQs) 6

Planning a Private M&A Transaction 6

Documenting an M&A Transaction 9

Regulatory Approvals 10

International Assets 15

Tax Matters 15

Employment and Labour Matters 18

Litigation Matters 21

Other Considerations 22

GOWLING WLG AT A GLANCE

Gowling WLG is an international law firm built on the belief that the best way to serve clients is to be in tune with their world, aligned with their opportunity and ambitious for their success. Around the globe, our 1,400-plus legal professionals and dedicated business support teams do just that. We bring our deep sector expertise to see the world through our clients' eyes and support their businesses.

Gowling WLG clients have access to expertise in key global sectors and a suite of legal services. With offices and specialized expertise in numerous countries the world over, we're well positioned to help clients achieve their objectives, — wherever their business takes them. We're proud to be recognized as a top employer, and actively encourage diversity and inclusion in our workplaces.

OUR M&A TEAM

Whether you're an emerging startup or a global corporation, the M&A lawyers at Gowling WLG have the experience you need to get the best deals done. Drawing on the collective expertise of an international law firm, we offer seamless service that's sophisticated, innovative and tailored to your legal needs.

As counsel to domestic and global clients, our top-tier professionals work with both publicly traded and privately held corporations, and are at the forefront of the fast-paced M&A world. From the start of your transaction through to closing, we can help you achieve your business goals.

INDUSTRY RECOGNITION

Thomson Reuters
Ranked Gowling WLG top Canadian law firm in first three quarters of 2018 for worldwide mid-market M&A transactions by deal count and top globally for Canadian mid-market M&A transactions by deal count

One of the Busiest Law Firms for Canadian M&A in H1 2018
Bloomberg ranked Gowling WLG (Canada) second among all law firms for the number of Canadian M&A advisory mandates in the first half of 2018

Legal 500 Canada | 2018
Recognized for Corporate and M&A, Mining, and Infrastructure and Projects

Canadian Legal Lexpert Directory | 2018
336 rankings across 50 areas of law, including Corporate Finance & Securities, Corporate Mid-Market, Energy, M&A, Mining and Private Equity

INTRODUCTION

This guide to private company M&A was developed by Gowling WLG to help business executives, foreign counsel and investors in the planning and execution of their private M&A transactions in Canada.

The content here is current as of September 2018 and is for general information purposes only. It is not a legal opinion or other professional advice.

If you are planning on buying or selling a private corporation in Canada, it is highly recommended that you seek detailed and specific advice from professionals experienced in M&A transactions.

For more information about private M&A transactions in Canada and the range of services that Gowling WLG provides, please visit us at **gowlingwlg.com/MA-canada.**

FREQUENTLY ASKED QUESTIONS (FAQS)

Here are answers we give to many of the frequently asked questions we receive from our clients, both international and domestic, as they look at acquiring Canadian corporations or their assets.

PLANNING A PRIVATE M&A TRANSACTION

1. How are mergers and acquisitions with private Canadian corporations typically structured?

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 the issued and outstanding shares of the target corporation from its shareholders. An asset sale involves the purchase of some or all of the assets (and perhaps the assumption of certain liabilities) of a corporation without acquiring the corporation itself. An asset purchase transaction is typical when only a single property or division is of interest, or the purchaser wishes to limit legacy liability exposure.

Depending on the circumstances, other more complicated methods might be required. 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 perhaps the holder of other securities) and court

Differences between Asset Transactions and Share Transactions

	ASSET TRANSACTION	SHARE TRANSACTION
Identity of seller	The corporation itself.	The shareholders of the corporation.
Transferred assets	Only those agreed to by the parties. All residual assets remain property of the seller.	All assets owned by the corporation remain with the corporation. There are no residual assets.
Assumed liabilities	Only those agreed to by the parties. All residual liabilities, including unknown liabilities, remain liabilities of the seller.	All liabilities of the corporation remain with the corporation. This includes all unknown liabilities including those that arise due to events occurring prior to the closing of the transaction.
Tax consequences to seller	Capital gains (or in some cases business income) and recapture on each asset that is transferred may arise. The allocation of the purchase price across the assets must be negotiated by the parties.	Potential capital gains (or in some cases business income) on the disposition of the shares may arise. In some circumstances, a capital gain may be offset by the lifetime capital gains deduction under Canadian tax law, which currently allows up to $848,252 (adjusted annually) of the capital gain on the sale of qualifying small business corporation shares to be taken by a seller tax free.
Tax consequences to buyer	The allocated purchase price becomes the cost base for assets and can be allocated to maximize future benefits. This allocation must be negotiated by the parties.	The purchase price of the shares becomes the cost base of the shares, which is relevant to future dispositions.
Due diligence	Limited to only those assets to be transferred as well as liabilities which may "follow" the assets.	More expansive as it is required for all aspects of the corporation and its business.
Consents and approvals	Determined by the assets that are transferred and may require consent or approval of counterparties to agreements or government agencies. If the assets being sold represent all or substantially all of the target's assets, an affirmative vote of shareholders holding two-thirds of the outstanding shares of the selling corporation will also be required.	Typically only required to the extent that an agreement, permit or licence has a change of control provision.
Legislative compliance	May be subject to review under the *Competition Act* and the *Investment Canada Act*.	May be subject to review under the *Competition Act* and the *Investment Canada Act*.

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 by a buyer and seller and typically involves significant input from the party's 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.

The table on the previous page sets out the primary differences between the two main transaction structures for the sale of a business that is carried on by a privately held corporation. The most suitable structure for a transaction will depend on a variety of factors and should be discussed with your legal and financial advisers.

2. What due diligence does a buyer generally conduct when considering the acquisition of a Canadian business?

Due diligence is the process undertaken by the buyer to familiarize itself with the business and assets of the target. The scope of the due diligence 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 (i) a review of the corporate records of the target corporation (as further described below), (ii) contracts to which the target corporation is a party, (iii) public searches in connection with corporate status, encumbrances and litigation, (iv) a review of the target corporation's intellectual property, (v) a review of certain governmental records regarding the target corporation that can only be accessed with the written consent of the target corporation (e.g. records related to tax, real property, employment or the environment) and (vi) 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 business of the target corporation and may help identify 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.

3. Are there restrictions on foreign ownership of shares or assets of a Canadian corporation?

Foreign investment is permitted and there are only a limited number of instances in which foreign ownership is restricted in Canada. The restrictions of broadest application are imposed by the *Investment Canada Act*. Additional restrictions are imposed in certain industries, such as broadcasting, telecommunications, oil and gas, mining, defence, and financial institutions by certain federal and provincial legislation. See further discussion on these issues in questions 8 through 11.

4. Is there an advantage to acquiring a private corporation through an amalgamation or a plan of arrangement?

An amalgamation is a statutory means to effect an acquisition by consolidating existing corporations into a single new corporation. Typically, the buyer would use an existing subsidiary or incorporate a new subsidiary to act as an acquisition vehicle. This subsidiary often obtains financing using the assets of the target corporation as security, since these assets will be owned by the subsidiary's successor by amalgamation. The acquisition is concluded by amalgamating that subsidiary with the target corporation.

To effect the acquisition by an amalgamation, the subsidiary (i.e. the acquisition vehicle) must be incorporated in the same jurisdiction as the target corporation. If, however, the existing subsidiary is in a different Canadian jurisdiction than the target corporation, one of the two can usually be continued into the other's jurisdiction as a preliminary step in order to facilitate the amalgamation.

A plan of arrangement works well if the target has a large number of shareholders and/or option holders or, if for other reasons, the transaction must be implemented through numerous steps. These steps might include amalgamations, amendment of articles,

transfers of assets, exchanges of shares or options and/or compromises with creditors.

Implementation of a plan of arrangement involves two court appearances and a shareholders' meeting. At the first court appearance, the court issues an interim order which provides for the calling of a special meeting of shareholders and sets out procedural matters. At the second court appearance, which occurs after approval at the shareholders' meeting, the court issues a final order approving the plan of arrangement.

Documentation typically includes an acquisition agreement, a plan of arrangement (setting out the transaction steps) and an information circular for the shareholders' meeting.

DOCUMENTING AN M&A TRANSACTION

5. What documentation is typically exchanged in an M&A transaction?

Regardless of the form of the transaction, the following documentation is typically entered into:

(a) **Letter of intent or term sheet.** A letter of intent (alternatively called a term sheet) is used by transacting parties to set out the principal terms of a proposed transaction and to otherwise describe the broad basis upon which the parties are prepared to complete the transaction. An important purpose of the letter of intent is to guide the expectations of the parties in the negotiation of the definitive agreement, including the form of the transaction, price, payment terms and closing date. Although most of the provisions of the letter of intent will be non-binding, it will usually contain provisions relating to confidentiality, expenses and exclusivity ("no-shop") which will be binding. Other binding provisions might include the non-solicitation of the target corporation's clients, customers and employees or break fees, where appropriate.

(b) **Non-disclosure/confidentiality agreement.** The target corporation will insist that any potential buyer enter into a non-disclosure/confidentiality agreement to prevent the buyer from disclosing any information learned about the business of the target during due diligence and the existence of negotiations.

(c) **Definitive purchase agreement and disclosure schedules.** Regardless of the transaction structure, a definitive purchase agreement will be negotiated and signed. The content of the definitive purchase agreement will generally include the following elements:

(i) A description of the transaction (i.e. in an asset purchase, the assets being acquired and any liabilities being assumed or excluded or, in a share purchase, the shares being acquired).

(ii) Details surrounding the purchase price, how it will be paid, any adjustments that may be contemplated such as a working capital adjustment or an earn-out.

(iii) Representations and warranties about the target and the business being purchased including with respect to assets, employees, financial statements, contracts, litigation, tax compliance and many other topics. The representations and warranties will often be qualified by referring to various disclosure schedules attached to the agreement that will contain specific information or qualifications to the representations and warranties being made.

(iv) Pre-closing covenants outlining any restrictions on how the business of the target is to be operated during the period between signing the purchase agreement and the closing.

(v) Any conditions to the parties' obligations to close, which often requires that no material adverse change in the business of the target occur and that all necessary third party or regulatory consents have been obtained.

(vi) The mechanics of closing, including the closing date and a description of the documentation which will be required to complete the transaction.

(vii) The indemnification obligations of the parties. Typically, the seller will indemnify the buyer for any breaches of the representations, warranties or covenants contained in the purchase agreement. These will be subject to various monetary limits and time limits which the parties will negotiate. The parties may also negotiate indemnities relating to specific liabilities or risks that were identified during the due diligence process (e.g. relating to environmental matters, litigation, taxes, etc.).

(e) Ancillary documents. Various ancillary documents will also be signed, including documentation to convey the assets or shares to the buyer. Other common ancillary documents include:

(i) **Non-competition, non-solicitation and confidentiality agreements.** Non-competition, non-solicitation and confidentiality agreements are signed to prevent the seller or the principals of the seller from starting a competing business following the closing and from soliciting the clients or employees of the target following closing.

(ii) **Employment/consulting agreements with key employees.** It is common that the principals of the target corporation or other key personnel will continue to work for the target for a period of time following closing and, as a result, will enter into employment/consulting agreements (see questions 28 and 29 on successor employer rules).

(iii) **Transition services agreement.** A transition services agreement is often signed in an asset transaction if only part of an operating business is being acquired. In these cases, the seller may be required to continue to provide certain services (i.e. payroll, IT services, office space, etc.) during a transition period following the closing.

6. Are transactional letters of intent enforceable in Canada?

The terms of a letter of intent are generally non-binding, except for binding terms pertaining to confidentiality, access to information, transaction expenses and exclusivity.

The language of the letter of intent itself is critical to a court's analysis as to whether the letter is a binding agreement. Passive language such as "propose" and "intend" can serve to advance the position that the parties intend the letter of intent to be non-binding. More definitive language such as "shall," "must" and "agree" may lead a court to find that binding obligations were intended by the letter of intent.

An effective way to avoid uncertainty is for the parties to state that all terms are non-binding until a definitive agreement is signed, with the exception of certain enumerated provisions that are binding and survive the termination of the letter of intent, even if a definitive agreement is not reached. If the letter of intent is silent as to which provisions are intended to be non-binding, a court may interpret the entire agreement as binding.

Care should also be taken to ensure that no unintentional obligation is created that requires the parties to enter into a definitive agreement.

REGULATORY APPROVALS

7. What typical regulatory approvals are needed for a non-Canadian buyer to acquire or invest in a Canadian corporation?

Acquisitions or investments that exceed certain thresholds are subject to review under the *Investment Canada Act* (foreign investment review) (see question 8) and pre-merger notification under the *Competition Act* (see question 12). Canadian M&A is generally based on free market principles, with minimal regulatory involvement.

8. How does the foreign investment review process apply to a non-Canadian buyer?

Foreign investment in Canada is regulated by the *Investment Canada Act*. Proposed acquisitions of "control" of a Canadian business that exceed certain monetary thresholds are subject to review under the Act.

Thresholds. Many different thresholds now apply and are summarized in the following tables:

Direct Acquisition of a Canadian Business

		NON-CULTURAL TARGET CANADIAN BUSINESS	CULTURAL TARGET CANADIAN BUSINESS	NATIONAL SECURITY
Trade Agreement Investors Applies where the investor is controlled by residents of a country or region with which Canada has a free trade agreement (U.S., EU, Mexico, Chile, Peru, Colombia, Panama, Honduras, South Korea) or where the Canadian business that is the subject of the investment is, immediately prior to the implementation of the investment, controlled by a Trade Agreement Investor.	Non state-owned enterprise (Non-SOE)	C$1.5 billion enterprise value*	C$5 million book value of assets	No threshold/discretionary
	State-owned enterprise (SOE)	C$398 million book value of assets	C$5 million book value of assets	No threshold/discretionary
WTO Member State Investor Applies where the investor is controlled by residents of a World Trade Organization member country or where the Canadian business that is the subject of the investment is, immediately prior to the implementation of the investment, controlled by a WTO Investor.	Non-SOE	C$1 billion enterprise value	C$5 million book value of assets	No threshold/discretionary
	SOE	C$398 million book value of assets	C$5 million book value of assets	No threshold/discretionary
Non-WTO Member State Investor Applies where the investor is controlled by residents of a country that is not a WTO member and where the Canadian business that is the subject of the investment is not, immediately prior to the implementation of the investment, controlled by a non-Canadian that is a WTO Member State Investor	Non-SOE or SOE	C$5 million book value of assets	C$5 million book value of assets	No threshold/discretionary

Indirect Acquisition of Canadian Business (i.e. acquisition of the shares of a non-Canadian corporation that has a Canadian subsidiary)

	NON-CULTURAL	CULTURAL	NATIONAL SECURITY
WTO Member State Investor (this group includes Trade Agreement investors)	Not reviewable	C$5 million or C$50 million book value of assets depending on the proportion of Canadian assets	No threshold/discretionary
Non-WTO Member State Investor	C$5 million or C$50 million book value of assets depending on the proportion of Canadian assets	C$5 million or C$50 million book value of assets depending on the proportion of Canadian assets	No threshold/discretionary

* While the formula for Enterprise Value depends on whether the transaction involves the acquisition of assets, the shares of a private company or the shares of a public company, subject to certain qualifications and exceptions it is essentially:

EV = Purchase Price or Market Capitalization + the target's liabilities other than operating liabilities – the target's cash and cash equivalents

Control. The *Investment Canada Act* includes detailed provisions defining the concept of an acquisition of "control."

In summary, these provisions state that control can be acquired only through the acquisition of: (i) voting shares of a corporation, (ii) "voting interests" of a non-corporate entity (which for partnerships and trusts means an ownership interest in the assets thereof that entitle the owner to receive a share of the profits and to share in the assets on dissolution) or (iii) all or substantially all of the assets of a Canadian business. For the purposes of determining whether an investor has acquired "control," the following general presumptions apply:

- The acquisition of greater than 50% of a target's voting shares is deemed to be an acquisition of control
- The acquisition of one-third or more, but less than a majority, of voting shares is presumed to be an acquisition of control, unless it can be shown that the acquired shares do not give the investor "control in fact" over the corporation (e.g. another shareholder owns a majority of the voting shares)
- The acquisition of less than one-third of the voting shares is deemed not to be an acquisition of control

Timing. The initial review period is 45 days from submission of an application for review. The Minister of Innovation, Science and Economic Development has a unilateral right to a 30-day extension. Further extensions can be agreed to between the Minister and the buyer. In our experience, the review period for large and complex transactions is typically between three and six months, due to the number of federal government departments and affected provincial governments which must be consulted.

Test. The standard of the review is whether the transaction is likely to be of "net benefit" to Canada. In applying this test, the Minister will review the investor's plans for the Canadian business (which are required to be set out in its application for review) with a view to assessing:

- The effect on the level of economic activity in Canada, on employment, on the utilization of parts and services produced in Canada, and on exports from Canada
- The degree and significance of participation by Canadians in the Canadian business
- The effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada
- The effect of the investment on competition within any industry in Canada
- The compatibility of the investment with national industrial, economic and cultural policies
- The contribution of the investment to Canada's ability to compete in world markets

Possible Outcomes. The Minister may either approve the acquisition or not approve the acquisition. Almost all proposed acquisitions are ultimately approved. Only a handful of high-profile and politically controversial transactions have been rejected.

Before an acquisition is approved, there is typically a negotiation between the investor and the Minister with respect to "undertakings" the investor is prepared to give in relation to the operation of the Canadian business post-acquisition. Such undertakings typically relate to the factors outlined above, and are intended to satisfy the minister of industry that the acquisition will be of net benefit to Canada.

In the recent economic climate, our experience has been that the Minister's primary concern has been to receive specific

undertakings with respect to employment levels at the Canadian business for a period of time post-acquisition (typically three years).

9. What is a "national security review"?

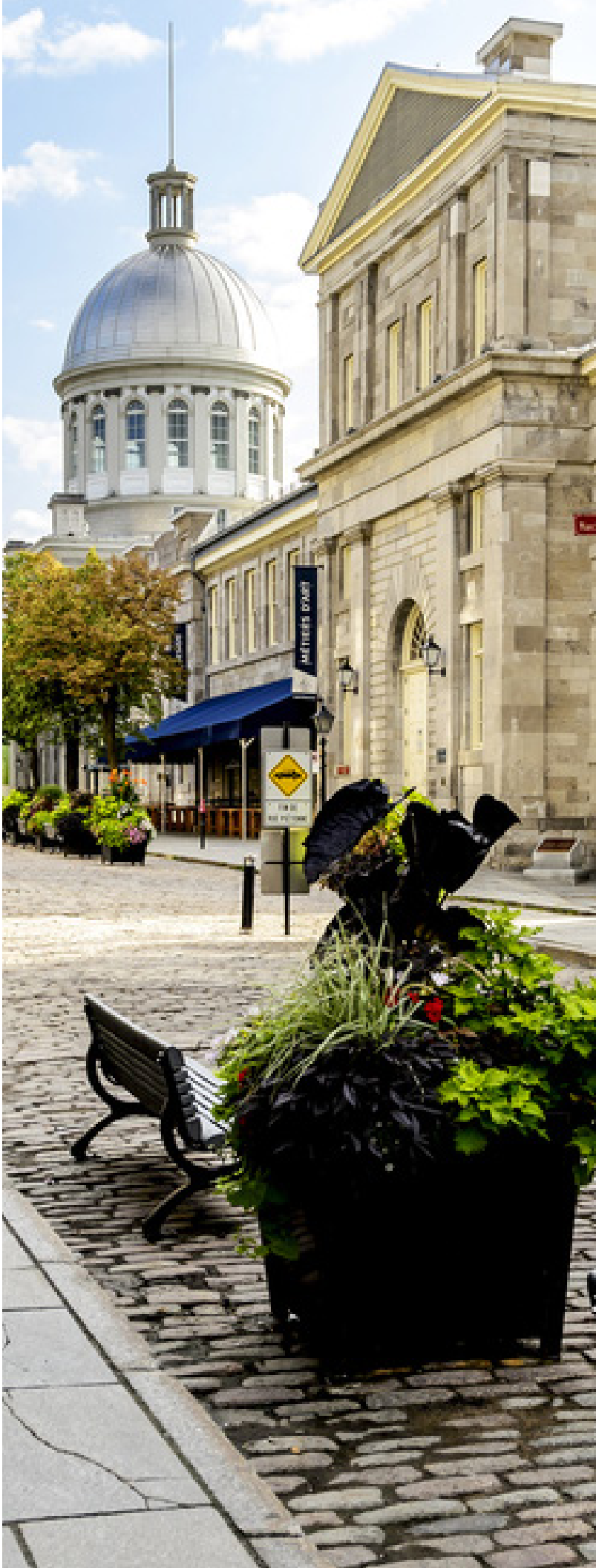
The *Investment Canada Act* provides the government with a right to review any foreign investment that "could be injurious to national security."

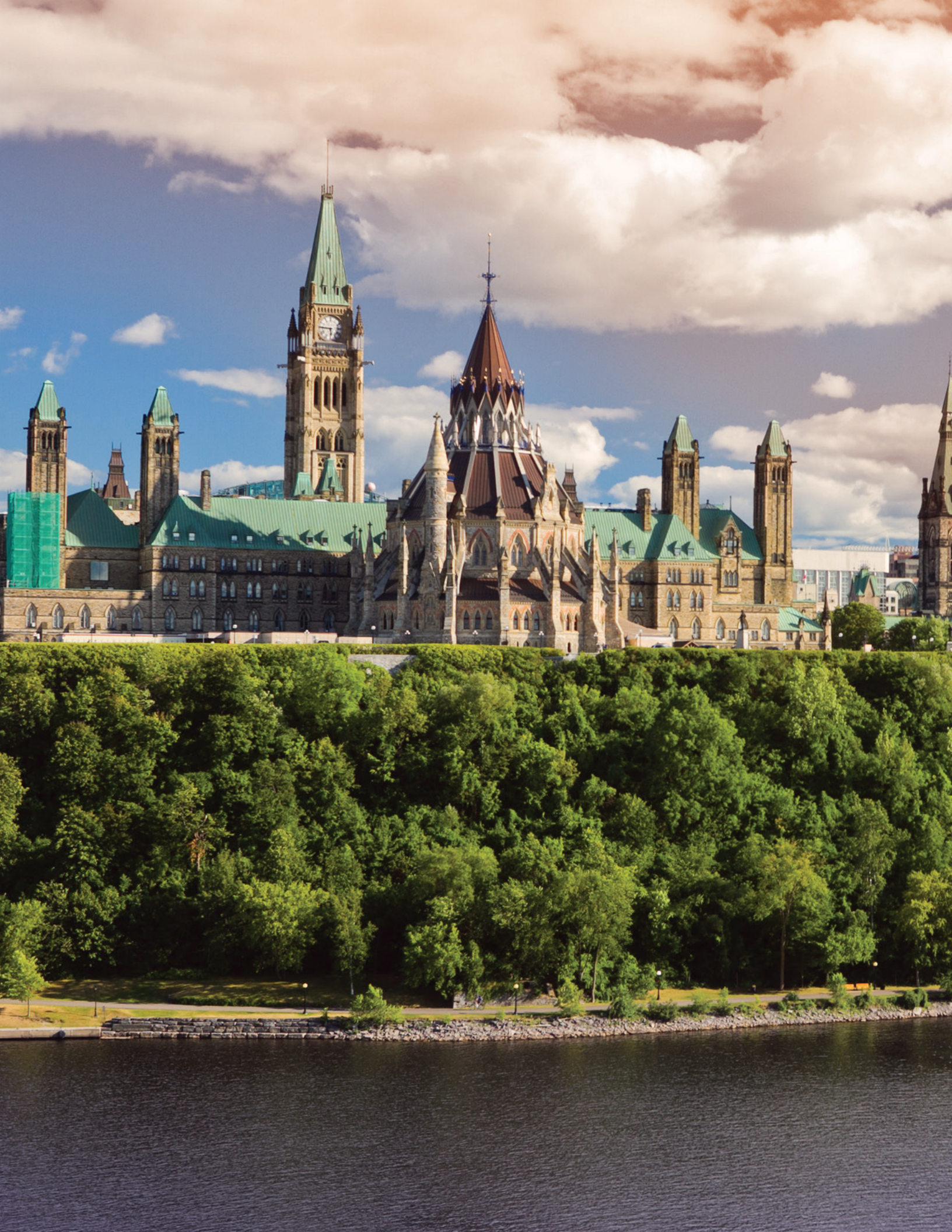
There is no minimum review threshold, and the national security review provision applies to minority investments and to the establishment of new Canadian businesses, not just the acquisition of "control" of existing Canadian businesses. The national security review can also apply to investments that have tenuous links to Canada (e.g. a business with any part of its operations in Canada). The national security review process can take up to 200 days or longer. The government may prohibit proposed investments, impose conditions on their completion or require divestiture of completed investments.

National security review guidelines issued by the government help investors assess the risk of a potential transaction triggering national security concerns. Included in the guidelines is a non-exhaustive list of factors the government will consider in assessing national security risk. The guidelines encourage investors to file their notification form at least 45 days before the planned closing date for the investment, particularly where any of the risk factors listed in the guidelines are present. If the government has not initiated the national security review process within 45 days from receiving a notification form, then it no longer has a right to do so and the investor will not subsequently face a potential divestiture order on national security grounds.

10. Will the Canadian government require that a Canadian partner be involved in the transaction?

The general rule is that a foreign investor is not required to invest alongside a majority or minority Canadian partner. Only in certain regulated industries that have Canadian minimum ownership limitations, such as uranium, telecommunications, banking and transportation, would a majority Canadian partner be required.





11. If we are considering involving a Canadian partner, would this eliminate foreign investment review?

If the applicable review threshold is exceeded, foreign investment review under the "net benefit to Canada" test would be avoided if the transaction is structured such that the non-Canadian investor does not acquire "control."

If the non-Canadian investor acquires control under the transaction and the review threshold is exceeded, then the "net benefit" test would apply whether or not there is a Canadian partner. It is possible that the presence of the Canadian partner may ameliorate political concerns in high-profile transactions; however, as noted above, this has never been required as a condition of approval.

As noted above, a discretionary national security review can be done even if the non-Canadian does not acquire a controlling interest.

12. How does competition review apply to Canadian M&A?

Notification of proposed transactions that exceed certain monetary thresholds must be provided before closing to the Competition Bureau, which can challenge any transaction that it believes will prevent or lessen, or is likely to prevent or lessen, competition substantially.

Notification is only required if both of the following thresholds are exceeded: (i) the parties, together with their affiliates, have assets in Canada, or annual gross revenues from sales in, from or into Canada, greater than $400 million, and (ii) the assets in Canada of the acquired business, or the annual gross revenues from sales in or from Canada generated by such assets, exceed $92 million. The $92 million figure applies in 2018. Generally, it is adjusted annually based on the change in Canada's GDP.

Note that in transactions involving the acquisition of voting securities, if these thresholds are exceeded, notification may be required, even if less than a majority of voting securities are being acquired (e.g. the acquisition of more than 20% of publicly traded voting securities).

The basic waiting period is 30 days from filing the prescribed notification form. The Competition Bureau has the power to issue a supplementary information request which extends the waiting period for an additional 30 days from compliance with such a request, as determined by the Bureau. The Bureau has various other powers to delay closing.

The test applied by the Bureau is whether the proposed transaction prevents or lessens, or is likely to prevent or lessen, competition substantially.

The most common outcome is for the Competition Bureau to indicate to the parties, at the conclusion of its review, that it does not plan to challenge the transaction. In a relatively small percentage of transactions, this is on the basis of a consent agreement with the parties to address the Bureau's concerns – e.g. the buyer agrees to sell some of the target's assets to a third party. It is extremely rare for the Bureau to challenge a transaction.

INTERNATIONAL ASSETS

13. Our Canadian target has international subsidiaries or assets. How does the process differ from buying a Canadian corporation which has Canadian assets only?

Foreign investment, competition and other approvals may be required in the relevant international jurisdictions. The specific mix of such approvals will vary depending on the jurisdictions and the nature and size of the target's operations in such jurisdictions. Canadian foreign investment review may not apply, depending on the circumstances.

14. Can we eliminate the Canadian ownership structure after we buy the corporation owning the international subsidiaries or assets?

Yes, there is typically full flexibility to eliminate the Canadian ownership structure post-acquisition. However, it is important to focus on this issue early as part of the transaction planning to optimize tax efficiencies.

TAX MATTERS

15. What vehicle should be used for a Canadian acquisition?

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.

16. What are the tax advantages to using a Canadian subsidiary?

These advantages may include: (i) facilitating the deduction of interest on financing for the acquisition against the income of the Canadian target, (ii) 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 (iii) 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 buys 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 on 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.

17. What are the advantages of incorporating a Canadian subsidiary under federal laws, rather than under provincial laws?

Corporations can be incorporated under Canadian federal law or under the laws of one of Canada's 10 provinces or three territories. A number of factors must be taken into account in determining where to incorporate, including differences between the corporate law in the various jurisdictions. If the business of the corporation will be conducted in only one province, the corporation is generally incorporated provincially. Certain statutes may require the use of a corporation formed under Canadian federal law or the laws of a particular province and sometimes (such as in the case of banks) under industry-specific legislation. Whether incorporated federally or provincially, a corporation must also register and may be required to obtain an extra provincial licence in any province in which it carries on business.

Foreign investors may be interested in the possibility of incorporating an "unlimited liability" corporation or forming a partnership or limited partnership under certain provincial laws to achieve certain tax objectives. They may also prefer some jurisdictions over others due to director residency requirements, record keeping requirements or the ability to appoint a nominal board that is stripped of its power through a unanimous shareholder agreement.

18. How would a Canadian subsidiary be taxed in Canada?

A subsidiary incorporated anywhere in Canada is considered to be a Canadian resident and subject to taxation in Canada on its worldwide income. A Canadian resident corporation is subject to both federal and provincial income tax.

In the early startup years of a subsidiary's business, operating losses may be incurred, in which case there would generally be no income tax payable by the subsidiary. Such business losses can be carried forward for 20 years to offset income earned after the operations become profitable.

19. Are there situations where a non-Canadian buyer would carry on the Canadian business directly?

In some situations where a non-Canadian buyer has other profitable operations, the buyer may wish to structure the acquisition as an asset purchase and carry on the operations initially as a branch of the buyer. This may allow the buyer to deduct the startup losses against the earnings from its other profitable operations. Whether this is feasible would also depend on the tax laws of the buyer's home jurisdiction. This type of structure is not common and must be implemented very carefully. For example, any non-Canadian buyer that carries on business in Canada may be required to pay Canadian income tax on any income it earns in Canada, particularly if it carries on that business through a permanent establishment in Canada. Difficult questions can arise in calculating the income that is derived from a Canadian permanent establishment. There are no clear guidelines for the calculations under Canadian law. In addition, the non-Canadian buyer must pay an additional Canadian branch tax based on the profits from the Canadian operation which are not reinvested in Canada.

Sales tax, value added tax and other indirect taxes may apply to an asset purchase. The non-Canadian buyer and its directors will also be responsible for Canadian payroll taxes and remittances for any employees who work in Canada. The books and records of the non-Canadian buyer may be subject to audit by the Canada Revenue Agency. For this reason, the use of fiscally transparent vehicles may be considered by a buyer that wishes to carry on a Canadian business.

In appropriate circumstances, it may be possible to convert a Canadian branch operation into a Canadian subsidiary on a tax efficient basis. A tax-deferred rollover may be available in Canada, thereby allowing a non-Canadian buyer to transfer the assets used in a branch operation to a Canadian subsidiary.

20. What are some of the Canadian withholding taxes that would apply to payment by the Canadian subsidiary to a non-Canadian parent?

Canadian withholding tax will be payable on the gross amount of dividends paid or credited by a Canadian subsidiary to any non-resident shareholder including a parent corporation. This tax must be deducted or withheld by the Canadian subsidiary on behalf of its parent corporation. The *Income Tax Act* (Canada) generally imposes a 25% withholding tax rate, but that rate may be reduced by an applicable tax treaty.

Canadian withholding tax also applies to interest that is paid by a Canadian subsidiary to a non-resident parent or to any other person with whom the subsidiary does not deal at arm's length. The withholding rate on interest is generally 25%, but may also be reduced or eliminated by an applicable tax treaty.

21. Are there situations where Canadian withholding tax does not apply?

The withholding tax on dividends only applies to payments that are dividends or similar distributions under corporate law. However, a return of capital that is properly made under Canadian corporate law by the Canadian subsidiary to its non-Canadian parent corporation is not generally treated as a dividend for Canadian income tax purposes. As a result, paid-up capital on shares of the Canadian subsidiary can generally be repaid free of Canadian withholding tax. To take advantage of this rule, advance planning is required and suitable share rights and capitalization of the subsidiary is necessary.

Interest paid to an arm's-length lender is free from Canadian withholding tax, as long as it is not participating-debt interest. Therefore, interest on loans from banks or other arm's-length parties outside of Canada directly to the Canadian subsidiary can be free of Canadian withholding tax in appropriate circumstances.

22. Are there any tax restrictions on how a non-Canadian parent funds the Canadian subsidiary?

One key decision for a non-Canadian buyer is whether to fund the Canadian subsidiary with debt or equity. A number of tax rules affect this decision. For example, interest on funding by way of debt is only deductible to the extent it is reasonable. As well, interest paid by a Canadian subsidiary to its non-Canadian parent will be subject to special requirements under Canadian transfer pricing rules. The subsidiary must be able to prove that the interest it pays is no more than the interest it would pay to an arm's-length lender, and it must have suitable supporting documents available to show to the Canadian tax authorities if requested.

Under Canadian tax rules, there is a restriction on the amount of interest a Canadian subsidiary can deduct on indebtedness owing to specified non-residents including its non-Canadian parent corporation. In order to have full interest deductibility, the debt-equity ratio for this indebtedness must not exceed three to two. This restriction is referred to as the thin capitalization rule.

23. Are there tax advantages to acquiring shares of a target rather than assets?

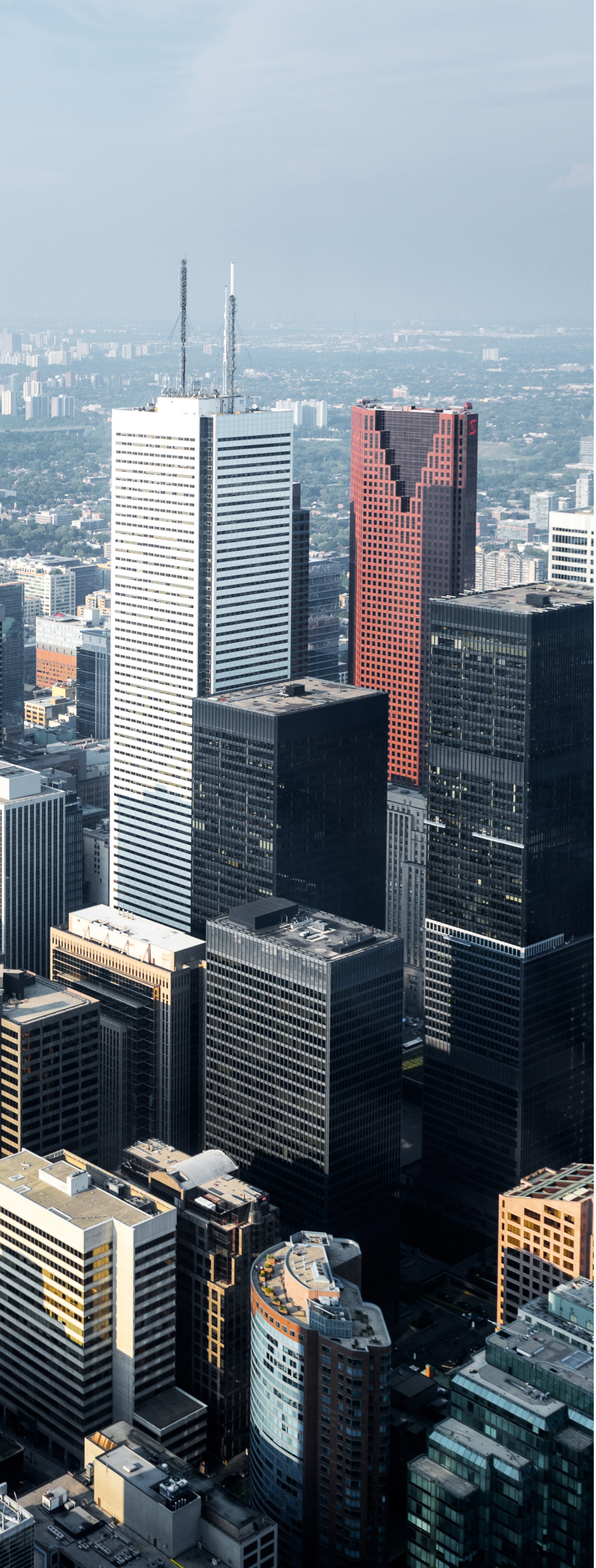
The acquisition of shares can be more tax efficient for shareholders of the target corporation compared to an asset purchase. Therefore, the shareholders of the target may be more inclined to structure a transaction as a share sale rather than as an asset sale.

In some cases, the target corporation may have advantageous tax pools such as non-capital loss carry forwards, Canadian exploration expenses, Canadian development expenses, scientific research and experimental development credits, net capital losses or other valuable tax attributes. In general, these tax attributes can only benefit the buyer if it purchases the shares of the target corporation rather than purchasing assets from the target corporation.

Where the target corporation has valuable tax attributes, it is important to structure the acquisition very carefully. This is because the Canadian tax rules contain a number of limitations on using the tax attributes of the target following an acquisition.

Where the target corporation has no special tax attributes, or where its assets have a very low tax basis compared to the purchase price, it may be advantageous for the buyer to acquire the assets directly rather than acquiring shares of the target. By acquiring the assets, the tax basis for the assets will be equal to the purchase price paid. This often gives rise to a high tax basis in the assets for the buyer, which can result in tax savings to the buyer in the future.

Where assets are purchased, it will be important to allocate the total purchase price among the various assets because certain Canadian tax consequences depend on the cost of the assets. For example, amounts reasonably allocated to inventory or depreciable property can be more tax efficient than amounts allocated to non-depreciable capital property.



24. What are some other key tax considerations?

Foreign affiliate dumping. If the Canadian target has foreign subsidiaries, special tax considerations will apply. Where a non-resident buyer purchases shares of a Canadian target that owns a foreign affiliate, the acquisition may trigger Canadian "foreign affiliate dumping" rules. These rules can result in adverse Canadian tax implications and therefore may require special structures.

Tax treaty considerations. International acquisitions must take into account the tax rules of all applicable jurisdictions, including the home jurisdiction of the buyer, not just Canadian tax rules. One important structural consideration for a non-resident buyer is selecting a suitable foreign jurisdiction through which to invest in the Canadian target. A jurisdiction that has a tax treaty with Canada is often preferable to a jurisdiction with no tax treaty. However, rules exist which are intended to prevent "treaty shopping" and these rules continue to evolve. Therefore, the choice of jurisdiction requires even more careful consideration than in the past.

Canadian transfer pricing rules. Transactions between related parties are generally taxed in Canada based on the price and terms that would have applied between arm's-length parties. This arm's-length principle is used to counteract the potential for abuse in dealings between related parties. The Canadian transfer pricing rules relate to all types of non-arm's-length inter-corporation transactions involving property, services, intangibles, as well as cost-contribution arrangements, research and development cost-sharing, loans, management fees and other transactions. As a result of these Canadian transfer pricing rules, a Canadian subsidiary is required to conduct transactions with its non-resident shareholders and other non-arm's-length parties on terms similar to those that would have applied to arm's-length parties.

The Canadian subsidiary must also prepare and retain certain transfer pricing documentation. Failure to do so may result in significant penalties if the parties are ultimately held to have transacted on other than arm's-length terms.

EMPLOYMENT AND LABOUR MATTERS

25. Does Canada have the concept of "employment at will"?

Canada does not recognize the concept of "employment at will." The employment relationship is a contract formed at the time employment is offered and accepted. Consequently, neither party can unilaterally change the terms of the employment relationship.

Any attempt to do so can be interpreted by the other party as a breach of the contract.

Terminations without notice or compensation are generally not permitted, unless the employer can prove "just cause," a very high standard which usually involves wilful misconduct, disobedience or wilful neglect of duty. As such, the vast majority of employer-initiated terminations in the non-unionized environment will be terminations "without cause. " Generally (with some exceptions for employees with less than three months of service), the employer will be obliged to provide some amount of advance notice (or compensation in lieu) and also, in some cases, statutory severance pay to an employee terminated without cause.

Applicable labour/employment statutes and case law constrain the scope of what constitutes just cause. These statutes are comprised of the Canada Labour Code for federally regulated corporations (e.g. aviation, telecommunications, banking and interprovincial transportation) and provincial labour/employment standards statutes (that apply in the province where the employee works) for provincially-regulated corporations (i.e. approximately 90% of employees). Several of these statutes also provide certain employees with a statutory right to challenge a dismissal as unjust, and to seek reinstatement and/or compensation. Unionized employees have the advantage of collective agreements which limit the ability of an employer to terminate without just cause.

26. What is the scope of an employer's severance obligations in Canada?

The scope of an employer's severance obligations will be determined by a combination of: (i) applicable labour/employment standards statutes, which impose mandatory minimum statutory notice/compensation in lieu (and, both federally and in Ontario, minimum statutory severance pay) requirements, (ii) the presence or absence of enforceable written termination provisions in an employment agreement, hiring letter or collective agreement, and (iii) in the absence of enforceable written provisions, the common law concept of "reasonable notice" (or in Québec, a roughly equivalent civil law concept).

The statutory minimum notice periods and statutory severance pay are based strictly upon length of service and the number of employees being terminated around the same time. They are not influenced by the employee's personal characteristics or market conditions. Statutory minimum notice entitlements are typically capped at eight weeks per employee. However, special notification requirements and enhanced statutory notice entitlements apply if a large number of employees are being terminated within a set time period (typically, 50 employees or more within four weeks or, in Québec, 10 or more over a period of two months). Statutory severance pay under the Canada Labour Code (after 12 months of continuous employment, two days' pay per completed year of service) and Ontario *Employment Standards Act*, 2000 (after a total of five years employment, one week's pay per completed year of service) is also payable.

Generally, absent enforceable written termination provisions, "reasonable notice" must be assessed on an individual basis. Key factors include age, role, length of service, and the availability of similar employment given the employee's experience, training and qualifications, but many other factors are relevant. Reasonable notice entitlements generally range between one week and 24 months (inclusive of any statutory entitlements). Longer notice periods can be awarded in extreme circumstances. Furthermore, except to the extent limited by enforceable contractual provisions, the termination package must cover all compensation elements (e.g. benefits, incentive/variable pay, car allowances), not just wages or salary.

Except in Québec, employers can contract out of the obligation to provide reasonable notice, as long as the contractual termination provisions fully comply with the minimum requirements of the applicable labour/employment standards legislation and are unambiguous. However, courts apply very strict enforceability tests to such termination provisions. In Québec, employers cannot contract out of the obligation to provide reasonable notice of termination.

27. What are a buyer's obligations toward the employees in a non-unionized workplace?

In a share purchase, because the employer remains the same, the employment agreements and employment terms between the target corporation and its employees in effect at closing will not change unless the buyer requires that changes be made by the target corporation prior to closing. Typically, indemnity provisions will be negotiated between the seller and buyer, but the target (and so, indirectly, the buyer) still remains responsible to satisfy all obligations to existing and ex-employees.

In the case of an asset purchase, except in Québec, the buyer is free to decide whether to employ the employees of the seller and except to the extent assumed by the buyer pursuant to the purchase agreement, and subject always to statutory successor employer rules, the buyer does not inherit pre-closing obligations. However, to the extent the buyer employs the employees of the target corporation post-closing, all jurisdictions have successor employer provisions in the applicable labour/employment standards legislation which protect the tenure of the seller's employees in the case of such a "sale of a business." The buyer is also responsible for all obligations to employees arising following the closing date. Negotiated indemnity provisions may reduce the buyer's exposure under statutory successor employer obligations, but the buyer still remains responsible to satisfy those obligations to the continued employees. In Québec, the buyer of assets is

restricted in selecting which employees of the seller it will employ and inherits most pre-closing obligations. See question 29 below for further detail about successor employer rules.

28. What is the difference between the obligations of a buyer of shares and a buyer of assets in a non-unionized workplace?

Except in Québec and subject to any contrary obligations in the purchase agreement, a buyer of assets: (i) is free to select which employees, if any, will be offered employment with the buyer, (ii) is not required to match pre-closing terms of employment (subject always to compliance with statutory requirements), and (iii) with very limited exceptions, will not have any obligations toward employees who are not offered or do not accept employment with the buyer.

Except in Québec and subject to any contrary provisions in the purchase agreement, a buyer of shares indirectly inherits all employees, all existing terms of employment, and all obligations on closing. A share purchase does not, in itself, change (or give the buyer any right to change) employment status or employment terms.

In Québec, the Civil Code and labour standards legislation provide that in any transaction for the acquisition of a business, whether by purchase of shares or assets, the employees of the acquired business are automatically entitled to continued employment with the buyer on terms and conditions substantially equivalent, in the aggregate, to those existing at closing.

29. Is it possible for a buyer of assets to re-employ the employees of the acquired business as new employees without past service?

For statutory purposes, generally, no. A buyer cannot simply employ the employees and ignore the employees' service history with the acquired business. However, for other purposes including common law reasonable notice, the answer is, generally, yes (except in Québec). Technically, 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).

For both federally and provincially regulated non-unionized businesses, 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, e.g., requires at least a 13- week period of non-employment to "break the chain"). Absent 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.

Except in Québec, in a non-unionized environment, there is an additional requirement if the buyer wants to "break the chain" for non-statutory purposes: the buyer must include enforceable written termination provisions in an employment agreement or hiring letter, clearly specifying that prior service will not be recognized except to the minimum extent strictly required by applicable labour/employmen 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.

30. To what agreements or outstanding claims should a buyer of shares pay special attention at the negotiation stage of the acquisition?

Typically, termination/severance and change of control obligations are embedded within employment agreements or hiring letters. Absent such written agreements in respect of termination obligations, the common law "reasonable notice" concept will apply and the potential liability to individual employees can be up to 24 months' notice/total compensation in lieu for each employee. A clear understanding of all termination/severance-related obligations is critical.

A buyer should carefully review all termination/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 payments tied to change of control are "single trigger" (triggered by closing, regardless of re-employment or continued 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).

31. Once the acquisition has been completed, can the buyer change the terms of employment of the workers it has re-employed?

As noted above, the employment relationship is a contract formed at the time employment is offered and accepted. Consequently, neither party can unilaterally change the terms of the employment

relationship. Except in Québec, a buyer of assets has significant control over terms of employment at the point of re-hiring. Accordingly, such changes should be implemented through employment agreements or hiring letters effective on closing. In contrast, 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 after 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 significantly disadvantageous to an employee (e.g. a 15% 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 of the changes may be unenforceable unless the buyer provided "fresh consideration (value)" to the employee (e.g. a signing bonus or stock option grant) at the time of making the changes. Mere continuation of employment is not sufficient "fresh consideration."

32. Should a buyer pay special attention to pensions and benefits provided to the target's employees?

Existing pension and benefit entitlements must be addressed if shares of the target are acquired. In the context of an asset purchase, they must be addressed if there is a collective agreement or employment contract that requires, by express or implied terms, such pension and other benefits to be provided. The manner in which these pension and benefit entitlements are addressed depends on the specific circumstances of the transaction and of the parties involved.

If the plans of the target are intended to continue following closing, the buyer should ensure that there are no significant underfunded liabilities. This is a particular concern for defined benefit pension plans and, as a result, most buyers prefer to avoid the assumption of such plans. Attention should also be paid to any post-employment/post-retirement health and welfare benefits provided by the target, which benefits typically are not funded. Assumption of such benefit plans could result in the assumption of a material liability for the buyer.

If any other benefit plans are assumed, care should be taken to determine whether they are insured by an insurance corporation or self-insured. Some insurance corporations provide policies for administrative services only ("ASO policies") so the existence of an insurance contract does not necessarily mean that benefit plan liabilities are insured. Another risk relates to insurance policies that are experience-rated. Negative experience rating could result in an additional charge post-closing if such a policy is assumed by the buyer.

Where a buyer assumes any plans provided by the target, it may assume responsibility for the liability associated with the mismanagement of such plans in the past. The existence of, or potential for, liabilities in respect of the target's pension and benefit plans may be material to decisions about whether to assume any such plans, how to structure the transaction and the representations, warranties, covenants and indemnities that are required.

In addition, employees generally must be enrolled in one of two statutory pension plans: the Canada Pension Plan or the Québec Pension Plan, and contributions are required to be paid by both the employer and the employee. Subject to compliance with any collective agreement and the employment law of the relevant jurisdiction, generally a buyer is not required to offer any other pension/retirement plan, or other benefits, to employees. The one exception is Québec, where certain employers who do not offer a pension or retirement plan must offer a "voluntary retirement savings plan" to eligible employees. If the buyer chooses to provide a new pension plan, pension benefits standards legislation in some jurisdictions requires that the new plan recognize service in the target's plan for the purposes of determining eligibility for membership, or entitlement to benefits (but not for purposes of determining the quantum of benefits).

Another issue to consider is whether the buyer has an existing pension plan, or other benefit plans, for which new employees would become eligible. Care should be taken to ensure that any employees of the target who are assumed or hired do not end up with double coverage (i.e. in existing buyer plans as well as any plans that are assumed or established by the buyer for the new employees) or a lack of coverage (e.g. employees become members of new plans but the insurer does not waive pre-existing conditions). To avoid these issues, before closing, the buyer should consider appropriate amendments to the existing buyer plans and/or suitable arrangements with the insurance corporations that provide coverage.

LITIGATION MATTERS

33. What is unique about litigation trends in Canada, including in class action lawsuits?

Unlike in the U.S., where shareholders commence class actions in connection with many public M&A transactions, Canada is unique in that there is very little shareholder litigation in connection with

M&A transactions. Shareholder class actions in Canada typically arise from misrepresentations by public companies that result in a drop in the share price when the misrepresentation is corrected.

When there is litigation in connection with private M&A transactions in Canada, it generally relates to claims for breach of representations and warranties, or to working capital adjustments. For public M&A transactions, litigation generally arises in connection with contested M&A transactions and can involve proceedings at securities tribunals and in the courts, where the oppression remedy under corporate statutes makes available a broad array of remedies to a successful claimant.

34. How can a buyer obtain information about ongoing or pending litigation against the target business?

Litigation searches can be conducted against a target as part of the due diligence process for an acquiring client. The information contained in the search result varies by province but, at a minimum, will reveal the names of the parties involved in the dispute. If more detailed information is required, it is possible to obtain copies of publicly-accessible court documents.

The Canadian provinces do not have a uniform procedure for litigation searches. In Ontario, for example, it is necessary to search the records of each judicial district separately, while in other provinces it is possible to conduct a single "province-wide" search. Most frequently, searches are conducted in the district of the target's registered office and principal place of business. Depending on the nature of the target's business and how concerned the buyer is about outstanding litigation, searches may also be conducted in other judicial districts.

OTHER CONSIDERATIONS

35. Does Canada have currency controls?

No. Canada has no currency controls.

36. What process is involved in bringing non-Canadian workers into Canada to work at a Canadian corporation acquired by a non-Canadian parent?

Canada's immigration programs and rules are designed to facilitate the entry of business people, managers and skilled workers.

Executives, senior managers and technical personnel needed to work in Canada to support an acquisition or a new Canadian-based corporation may apply for work permits to allow them to work in Canada on behalf of a foreign business or a related Canadian entity. To be eligible for a work permit, the applicant must qualify under one of Canada's work permit categories. Workers from a foreign acquiring corporation are often eligible for intra-company transfer work permits allowing them to work for the acquired Canadian corporation. These are available to eligible managerial-level employees or key specialists who are being transferred from an employer outside of Canada to a related Canadian entity, where the worker has worked for the related foreign corporation for at least 12 months. Note that the ownership structure between the foreign corporation and the acquired Canadian entity is an important consideration as it will affect whether an intra-company transfer work permit is possible.

Depending on the citizenship and country of residence of the worker, a work permit application may be filed at the port of entry in Canada, or online to a Canadian visa office. Citizens of countries that require a temporary resident visa (TRV) must apply through a visa office. When the visa office approves an application, it will issue a TRV and a letter of authorization allowing the worker to travel to Canada. The work permit itself is then issued at the port of entry to Canada.

In some cases where the intra-company transferee category is not available, it is necessary to first obtain a labour market impact assessment (LMIA) from the Canadian government before the work permit application can be made. This is done by way of an application filed in Canada. Several criteria must be met. For example, it must be shown that qualified Canadian workers are not available and the wage being offered must meet the prevailing wage rate for the occupation and the location of the work.

Canada has also entered into a number of free trade agreements that contain mobility and entry provisions applicable to citizens of eligible countries. Free trade agreements may provide work permit options to citizens of the United States, Mexico, Peru, Chile, Colombia, South Korea and the EU.

Accompanying spouses of foreign nationals working in Canada may apply for a work permit under the Spousal Employment Program. Temporary immigration documentation may also be obtained for accompanying children.

When acquiring a Canadian entity, a list of Canadian-based employees should be reviewed since anyone holding a Canadian work permit may need to obtain a new work permit, depending on the nature of the acquisition. Canada's immigration department has a policy on work permits when an acquisition or a corporate restructuring occurs.

37. What are the significant and unique elements of the Canadian restructuring and insolvency regime that impact on the acquisition of a distressed business in Canada?

The buyer of a seriously financially distressed business in Canada faces many of the same challenges that would be presented in the U.S. and other jurisdictions. If the target is insolvent or "in the zone" of insolvency, time is critical in attempting to preserve enterprise value. Although a buyer of a distressed business will want to try to control the speed and scope of any sale process, Canadian courts 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/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, to gain access to valuable due diligence on the target and, importantly, to participate in the formulation of the sale process to the greatest extent possible. Agreeing to be the "stalking horse bidder" may also permit a buyer to participate in the formulation of the competitive sale process from a structural and timing perspective and to set a price floor and a modest break fee. Break fees are negotiated but are generally smaller in Canada than in the U.S.

The use of credit bidding in a Canadian court-supervised sale process (whether in reorganization or receivership proceedings) is becoming a prevalent feature in distressed M&A activity. Canadian court-supervised sale processes in many instances have adopted the standard features of the U.S. sale process: using a competitive or auction model. 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 (as a stalking horse bid or a permitted bid in the general process). Some buyers will acquire senior secured debt to gain more control of a sale process and to permit a credit bid. There are significant pros and cons to this approach which need to be examined on a case-by-case basis.

38. What are some key risk allocation features in Canadian acquisition agreements that differ from those in American and European acquisition agreements?

There are a number of differences in risk allocation features in acquisition agreements between deals completed in Canada, the U.S. and Europe.* These differences include survival periods for representations and warranties, the scope of damage/indemnity caps, the type of indemnity claim baskets and the prevalence of earn-outs, as follows:

- Canadian deals generally have longer survival periods for representations and warranties, with 31% of deals having periods that are 24 months or longer, compared to only 15% in the U.S. By comparison, at 24%, European deals are higher than American deals but lower than Canadian deals.
- Damage caps are much lower in the U.S. as compared to both Canada and Europe. Damages in 50% of all American deals were capped at less than 10% of the purchase price, and only 3% of American deals permitted the entire purchase price to be recovered. In Europe, 21% of deals had caps of less than 10% of the purchase price and 7% were capped at the purchase price. By comparison, only 7% of Canadian deals were capped at less than 10% of the purchase price and 23% were capped at the purchase price. Overall 55% of Canadian deals had caps of at least 25% of the purchase price compared to 8% of American deals and 65% of European deals.
- The vast majority of acquisition agreements (in Canada, the US and Europe) contain some sort of basket as a means of limiting indemnification claims (i.e. a threshold amount of damages that must be aggregated before a claim can be made); however, the type of basket is often different. In American deals, 65% have deductible baskets, where claims can only be made for amounts that exceed the threshold, as compared to only 41% for Canadian deals and only 5% for European deals. Inversely, first dollar or tipping baskets, where claims can be made for the full amount of damages once the threshold is exceeded (with no deduction of the threshold amount) are more common in Canadian deals (45%) and European deals (73%) as opposed to American deals, where only 26% had first dollar or tipping baskets.
- American deals more commonly include an earn-out (i.e. a right for the vendors to receive additional payment upon the target business meeting certain post-closing financial performance metrics) as a purchase price adjustment in acquisition agreements. In American deals, 26% included an earn-out provision as compared to only 17% for Canadian deals. The European study did not track earn-outs.

** We have identified these differences by comparing three private target deal point studies published by the American Bar Association: one for Canada in 2016 that covers deals completed in 2014 and 2015, one for the United States in 2015 that covers deals completed in 2014 and one for Europe in 2017 that covers deals completed in 2014, 2015 and 2016.. The Canadian and American studies sampled transactions in which private corporations were purchased by public corporations where the purchase agreements were filed publicly on SEDAR or EDGAR, while the European study sampled transactions in which private corporations were purchased by public or private corporations.*

Gowling WLG (Canada) LLP
gowlingwlg.com