

PRIVATE

EQUITY

BULLETIN

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PRIVATE EQUITY INVESTMENT IN CANADA

INTRODUCTION

Canada has become an attractive source of investment opportunities for foreign private equity investors, particularly US investors. In addition to two large transactions led by KKR (the acquisition of Shoppers Drug Mart and the telephone directories business of BCE), there have been a significant number of private equity transactions in the \$15-50 million dollar range in recent years.

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

- *Favourable Market Conditions.* The market is under-served.
- *Economic Performance.* The Canadian economy has performed well relative to the US economy in recent years (eg, Canada's inflation rate has been marginally lower than, and its economic growth has outpaced, that of the US).
- *Jurisdictional Risk and Compatibility.* Canada offers low jurisdictional risk because of the relative similarity of the Canadian and US legal systems. In addition, most standard US deal terms (eg, liquidation preferences, registration rights and governance) can be implemented in Canada with relatively few changes.

Private Equity Market – Canada vs. US

- The level of private equity investment in Canada is lower than in the US (4.7% of GDP in Canada compared to 6.8% in the US).
- The market for private equity in Canada is less concentrated than in the US (the 25 largest funds account for approximately 12.5% of the market in Canada compared to approximately 68% in the US).
- In 2002, approximately 30% of large and 12% of mid-sized pension funds in Canada had private equity investments compared with 41% and 20% in the US.
- Private equity investments comprise 5.8%, 1.6% and 0.8% of the assets of large, mid-sized and small Canadian investment funds compared with 7.8%, 8.6% and 6.5% in the US.

What follows is:

- an overview of the relevant Canadian legal framework;
- a summary of certain Canadian legal/investment considerations; and
- a summary of applicable recent legal developments.

LEGAL FRAMEWORK

Corporate Statutes

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

Securities Regulation

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

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

Going Private Transactions – Ontario Securities Commission Rule 61-501

- OSC Rule 61-501 attempts to ensure fair dealing in the treatment of minority shareholders in connection with transactions whereby minority holdings in Canadian public companies are eliminated by a controlling shareholder (these so-called “going private” transactions may be effected by way of a first stage transaction consisting of an amalgamation or a statutory arrangement or a second stage transaction following an initial tender offer).
- The Rule requires a formal valuation to be prepared by an independent valuer with respect to the shares held by minority shareholders. The Rule does not permit downward adjustment to reflect liquidity or lack thereof, the effect of the transaction on the minority’s shares or the fact that the shares do not form part of a controlling interest. The formal valuation report is required to be included in the disclosure material relating to the transaction.
- The Rule typically requires approval by a majority of the “minority” or disinterested shareholders (either by way of a minimum tender condition or by way of a shareholder vote, depending on the structure of the transaction).
- The Rule recommends the use of a special committee of independent directors to carry out negotiations with the controlling shareholder or “related parties” and provides that it is essential, in connection with the disclosure, valuation, review and approval processes, that all securityholders be treated in a manner that is fair and that is perceived to be fair.

LEGAL/INVESTMENT CONSIDERATIONS

Ownership Restrictions

Canada imposes certain restrictions on foreign ownership including:

- *Investment Canada Act (“ICA”).* The acquisition by a non-Canadian of “control” of a Canadian business which exceeds certain prescribed monetary thresholds is reviewable under the ICA and subject to approval by the federal Minister of Industry or the Minister of Heritage (depending on the nature of the business of the Canadian company). Transactions below the applicable threshold are subject to a “tick-the-box” notification process. For purposes of the ICA, the acquisition of one-third or more of the voting shares of a Canadian corporation will be presumed to be an acquisition of control unless it can be established that, on the acquisition, the corporation is not controlled in fact by the acquiror through the ownership of voting shares.
- *Other Restrictions.* Certain other federal statutes limit foreign ownership in specified industries, such as financial services, broadcasting and telecommunications (eg, non-Canadians are not permitted to own more than one-third of the voting shares of a holding company which has a subsidiary operating company licensed under the *Broadcasting Act*).

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

Income Tax Considerations

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

- *Capital Gains on Sale of Equity Interest.* In general, foreign investors are subject to Canadian tax on

capital gains realized on a sale or other disposition of shares of a Canadian private company or a Canadian public company where certain ownership thresholds are satisfied. Many of Canada’s income tax treaties include exemptions from this tax. For example, under the *Canada-United States Income Tax Convention* (the “US Treaty”), capital gains on shares of a Canadian company held by a US resident entitled to the benefits of the US Treaty are exempt from Canadian tax, provided that the shares do not derive their value principally from Canadian real property. Even where a gain on shares of a Canadian company (other than shares that are listed on a stock exchange prescribed for this purpose) is exempt from Canadian tax, a foreign private equity investor will be required to comply with Canadian reporting requirements.

- *Withholding Tax.* Dividend and interest payments made by a Canadian company to a foreign equity investor are generally subject to a 25% withholding tax. The withholding tax rate may be reduced under an income tax treaty. Under most of Canada’s tax treaties, the withholding tax rate on interest is reduced to 10%. The withholding tax rate on dividends is generally reduced to 15%, subject to a further reduction to 5% or 10% if certain share ownership thresholds are satisfied. Under the US Treaty, the dividend withholding tax rate is 5% if the US resident shareholder owns at least 10% of the voting stock of the Canadian company. Additional exemptions from Canadian withholding tax on interest and dividends may be available to pension funds or charitable organizations that are exempt from tax in the jurisdiction in which they are resident.
- *Management and Administration Fees.* Management and administration fees paid by a Canadian resident to an arm’s length non-resident for services provided by the non-resident in the ordinary course of the non-resident’s services business are not subject to Canadian withholding tax. Where these conditions are not met, there is a 25% withholding tax. For the purpose of most of Canada’s income tax treaties, including the US Treaty, however, management and administration fees are considered to be business profits and are not subject to Canadian tax unless the non-resident provides the services through a

Canadian “permanent establishment”. Ontario imposes what is effectively an indirect 5% withholding tax on certain management fees (and other amounts such as rents and royalties) paid to non-arm’s length non-residents by denying the deduction of a portion of these amounts.

- *Thin Capitalization Rules.* Canadian thin capitalization rules prohibit Canadian companies from deducting interest on the portion of interest-bearing loans from specified non-residents that exceeds two times the “tax equity” of the specified non-residents in the Canadian company (generally, unconsolidated retained earnings plus outstanding share capital and contributed surplus attributable to the specified non-residents). For this purpose, a “specified non-resident” is any non-resident that holds shares representing 25% or more of the votes attached to, or the fair market value of, the outstanding shares of the Canadian company or that does not deal at arm’s length with any such shareholder.

It is important to note that the current administrative position of the Canadian revenue authorities is that US “unlimited liability companies” that elect to be taxed as partnerships are not entitled to be benefits of the US Treaty. In addition, Canada treats partnerships as flow-through entities and the partners are treated as the recipients of the interest and dividends received, and the capital gains recognized, by the partnership.

Accordingly, where the investor in a Canadian company is a partnership, whether or not treaty benefits are available to the partnership depends on the residence of the partners.

Insolvency Matters

Foreign private equity investors should also be familiar with Canada’s insolvency laws.

- *Receivership.* Creditors can initiate a receivership either privately or by court appointment. A private receivership is initiated when a secured party exercises a contractual right to appoint a receiver pursuant to a security agreement. Private receivership is usually the quickest and least expensive alternative for secured creditors. If there is opposition from a debtor or there are other factors requiring intervention by a court, a secured creditor may apply for a court-appointed receiver. In either a private or a

court appointment, the receiver can be authorized to operate the business of a debtor where it is necessary or advisable.

- *Bankruptcy and Insolvency Act (“BIA”).* Under the BIA, creditors may commence bankruptcy proceedings by filing a petition against the debtor corporation. The debtor must owe the petitioning creditor at least \$1,000 on an unsecured basis and the debtor must have committed an act of bankruptcy (eg, failing to meet its liabilities as they become due) in the six months preceding the date of the petition. If the debtor does not oppose the petition, the creditor may obtain a bankruptcy receiving order ten days after the debtor is served with the petition. Once a receiving order is made against it, the debtor’s assets will vest in the trustee in bankruptcy, subject to the rights of secured creditors.

The BIA allows a debtor to make a proposal to all of its unsecured creditors, which may, at the debtor’s option, include secured creditors. To be accepted, each class of creditors must vote to accept the proposal by a majority in number and two-thirds in value. A proposal that is opposed by secured creditors will not be binding on the secured creditors.

- *Companies’ Creditors Arrangement Act (“CCAA”).* The CCAA allows an insolvent corporation with claims against it exceeding \$5 million to make a compromise or arrangement with some or all of its secured and unsecured creditors while continuing to operate its business. The plan of compromise or arrangement must be approved by a majority in number and two-thirds in value of each class of creditors voting. Once approved by the creditors, the court must sanction the plan. Once sanctioned, the plan is binding on all the creditors included in the plan.

The proposal procedure under the BIA and proceedings initiated under the CCAA are primarily debtor-driven and are somewhat analogous to proceedings under Chapter 11 of the *United States Bankruptcy Code*.

Generally, the proposal procedures under the BIA are less costly and take less time to complete than proceedings under the CCAA. However, the rules and timelines for BIA proposals are more rigid and the courts have less discretion than under the CCAA which has very few procedural requirements.

RECENT DEVELOPMENTS

Corporate Governance

In response to Sarbanes-Oxley and related developments in the US, the Ontario government has recently proposed amendments to its securities legislation which contemplate, among other things, civil liability for misrepresentations in continuous disclosure documents of public companies and rule making authority for the Ontario Securities Commission with respect to audit committees, internal controls and CEO/CFO certification of the accuracy of financial statements. As a result of these developments, directors of Canadian public companies (including the nominees of private equity investors) will be subject to standards comparable to those of US companies subject to Sarbanes-Oxley.

Income Trusts

The combination of favourable valuations and the demand for yield in the Canadian capital markets over the last two years has provided foreign private equity investors with an additional exit/liquidity mechanism for their investments – the income trust.

An income trust is a trust that invests in operating assets that produce a stable or predictable stream of income. Like the stock of public companies, the units of the trust

are publicly traded on a stock exchange. Unlike many public companies, however, income trusts pay out most of their cash flow to unitholders on a regular basis, usually through monthly distributions. The income trust structure generally allows pre-tax operating income to be distributed to unitholders, reducing or eliminating corporate or asset-level tax.

The typical income trust structure involves a trust in Canada which is taken public through an offering of units to the public for cash. The trust then invests the proceeds of the offering in shares and subordinated debt of another newly formed company which in turn acquires the outstanding equity interests of the entity that owns the operating assets.

The Ontario government has recently introduced legislation which is intended to clarify that unitholders of publicly traded income trusts are not liable for the activities of the trust, thereby putting such investors in the same position as shareholders of corporations. Although unitholder liability was considered remote by most legal advisors, the proposed legislation is expected to eliminate the uncertainty that had made the income trust a less desirable investment vehicle for many institutional investors.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

McMillan Binch is one of Canada's leading business law firms, comprising over 160 lawyers, all based in Toronto. The firm has an established Private Equity Group comprising over 25 lawyers, with a broad range of experience across a wide range of industry sectors.

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