Fraser Milner Casgrain LLP

LEGAL GUIDE

Mergers and Acquisitions in Canada

FMC LAW

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Forward

This publication has been prepared to provide a general overview of the principal securities, tax, competition, foreign investment, labour relations, employment and pensions considerations that would be applicable in the acquisition of a Canadian business. Most of the material contained in this publication focuses on federal, British Columbia, Alberta, Ontario and Quebec legislation. The material is not meant to be an exhaustive analysis of the law and should not be relied on with respect to any particular transaction or other proceeding. Persons considering the acquisition of a business in Canada should obtain professional advice from any of the offices of Fraser Milner Casgrain LLP.

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Introduction

This guide is intended to outline the principal legal considerations pertinent to the acquisition of a Canadian business. The information is based on the assumption that the reader is a non-resident of Canada. With few exceptions, the same considerations apply where all of the parties are based in Canada.

This guide addresses a myriad of mergers and acquisitions issues, including:

1. securities law requirements;
2. tax considerations;
3. competition (antitrust) law requirements;
4. foreign investment requirements under the *Investment Canada Act*;
5. labour relations and employment considerations; and
6. pensions and benefits.

The contents and comments contained in this guide are for general information purposes only. This guide is not intended as a substitute for specific legal advice and should not be relied upon with respect to any particular transaction or circumstance. The information is provided as of the date set out below, and thus the reader is cautioned that changes or developments in the law, or its interpretation, may have occurred since that time.

If you are interested in buying or selling a Canadian business, Fraser Milner Casgrain LLP would be pleased to assist with your transaction. As a full-service business law firm with offices in all of Canada's major business centres, an in-depth understanding of each of Canada's leading industries and a pragmatic approach dedicated to timely client service, we are uniquely positioned to provide the legal and business advice you need to make your transaction a success.

September 2011

Overview of Canadian Securities Legislation

Introduction

The acquisition of a public company is a complex matter which requires knowledge of corporate and securities law, tax law and competition (antitrust) law. The issues are even more challenging when the buyer, the target company and their respective shareholders, are residents of different countries. This discussion provides an overview of Canadian corporate and securities law applicable to mergers and acquisitions, and highlights certain considerations and issues faced by a non-Canadian entity considering a share acquisition of a Canadian public company. For the purpose of this discussion, it has been assumed that the buyer owns less than 10% of the outstanding shares of the Canadian target company and that the target is a "foreign private issuer" under U.S. securities laws.

Overview of Canadian Securities Legislation

Although securities regulations in Canada and many other countries, including the U.S., are based on similar principles, there are certain key distinctions. The first is that there is no federal securities legislation in Canada. Securities regulation is solely a matter of provincial or territorial jurisdiction, and is governed by the securities legislation of each of the 10 provinces and three territories of Canada. However, with respect to take-over bids, the laws of the Canadian jurisdictions are virtually identical. All of the jurisdictions, with the exception of Ontario, have adopted Multilateral Instrument 62-104 – *Take-over Bids and Issuer Bids* ("MI 62-104"), which governs the securities law aspects of take-over bids. Ontario's legislation[1] has some differences in form, but is the same in substance as MI 62-104.

A second key distinction between Canadian securities legislation and the legislation of other countries, such as the U.S., is that Canadian securities legislation is not based on a "registration system". In Canada, a distribution of securities may only be made:

1. pursuant to a prospectus which has been filed with and receipted (accepted) by the securities regulatory bodies in the provinces and territories in which the securities will be issued;
2. pursuant to an exemption from the prospectus requirement in such jurisdictions; or
3. pursuant to a discretionary order granted by the applicable securities commission.

The definition of "distribution" includes an issuance of previously unissued securities of an issuer, a trade of securities held by a control person, and a first trade in securities previously acquired pursuant to a prospectus exemption, unless certain conditions are met. These conditions may include a four-month hold period on securities acquired under a prospectus exemption, depending on which exemption was used. In addition to permitting a distribution, the receipt of a prospectus will also trigger continuous reporting obligations for the issuer under the securities legislation of the provinces and territories in which the prospectus was filed.

1 Part XX of Ontario's *Securities Act*, R.S.O 1990, Chapter 5.5, ("OSA"); and Ontario Securities Commission Rule 62-504 – *Take-Over Bids and Issuer Bids* ("Ont. Rule 62-504").

Take-Over Bids

Share acquisitions of Canadian public companies are usually structured as either a take-over bid or a court-approved plan of arrangement (which may involve an amalgamation, capital reorganization or share exchange).

A "take-over bid" is generally defined in securities law as an offer to acquire voting or equity securities of an issuer that is made to one or more persons, any of whom is in the legislating jurisdiction, if the securities subject to the offer, together with the securities held by the offeror, constitute in the aggregate 20% or more of the outstanding securities of that class at the date of the offer.[2]

In Canada, the term "take-over bid" refers to an offer made directly to the shareholders of the target, whether the offeror is offering cash, securities or a combination of both to the target shareholders (although sometimes a take-over bid that offers shares as consideration is referred to as a "share exchange take-over bid"). This differs from the terminology in the U.S. which generally refers to cash take-over bids as "tender offers," and take-over bids in which shares are offered as consideration as "share exchange offers." For the purpose of this discussion, a take-over bid refers to a take-over bid made by way of a take-over bid circular, not a bid which is exempt from the take-over bid rules.

In the U.S., the Office of Mergers and Acquisitions of the Securities and Exchange Commission (the "SEC") reviews each tender offer for compliance with the rules. When securities are offered, the applicable industry group of the Division of Corporate Finance reviews the registration statement for the offered securities. In Canada, no securities commission is statutorily required to review a take-over bid circular prior to its mailing or upon its filing with the appropriate securities commission, regardless of the consideration offered.[3] As a result, there is no significant timing difference in Canada between the mailing of a take-over bid where cash is offered and one in which shares are offered. In addition, the period of time between the announcement of the transaction and the mailing of the take-over bid circular, particularly in the context of a hostile take-over bid, can be very short (i.e. within one or two days of receipt of the security holders list, which usually takes 10 days to obtain).

Advantages and Disadvantages

A take-over bid has certain advantages over a plan of arrangement and is generally the only alternative where the offer is unsolicited. The overall time frame to complete a take-over bid is shorter (35 days versus 60-plus days), although this shorter time frame may not be of significant assistance to the offeror if filings under the *Competition Act*[4] (Canada) are required. A take-over bid is usually less costly than a plan of arrangement (unless the offeror is an insider of the target, which may require an independent valuation).

On the other hand, a take-over bid also has certain disadvantages. The first is the risk that less than 90% of the outstanding shares are tendered to the bid. If the offeror is able to acquire 90% or more of the outstanding shares of the target (other than shares held by the offeror at the commencement of the bid), then the balance of the shares may be acquired through a statutory compulsory acquisition process often referred to as a "squeeze-out" transaction. However, if the offeror is only successful in acquiring between $66^{2/3}$% and

2 MI 62-104, s. 1.1; OSA, ss. 89(1).

3 In practice, the staff of some securities commissions may review filed take-over bid circulars to ensure material compliance with the procedural and disclosure rules.

4 R.S., 1985, c. C-34.

90% of the outstanding shares, then a second-stage transaction, such as a plan of arrangement or amalgamation, would need to be completed in order to obtain the balance of the shares of the target company.

The take-over bid rules are more restrictive than the requirements related to a plan of arrangement. They restrict the conferring of collateral benefits on security holders, which may become problematic where the offeror wants to enter into collateral agreements with senior management who are also shareholders. The take-over bid rules also strictly control purchases of the shares which are subject to the bid, prior to, during and after the bid. Due diligence is generally more difficult in a take-over bid, particularly in a hostile bid where the offeror will be limited to the public record. However, even in a friendly bid, representations and warranties are generally not provided by the target. Finally, where more than a nominal number of beneficial holders of securities reside in Quebec, the take-over bid circular must be translated into French, whereas a management proxy circular in respect of a plan of arrangement or amalgamation generally does not.

Commencing a Take-Over Bid

A take-over bid may be commenced by publishing an advertisement in the newspaper (in which case the date of the take-over bid is deemed to be the date of publication) or by sending the circular to the shareholders of the offeree company (in which case the date of the take-over bid is deemed to be the date of mailing). In either case, the bid must be open for at least 35 full days from the date of the bid.

Acquisitions Outside of the Bid

Pre-Bid Purchases

For various reasons, it may be advantageous for an offeror to secretly acquire shares of the target prior to the commencement of the bid. This practice is referred to as acquiring a "toe-hold" position. Securities legislation generally requires that, if the offeror acquires beneficial ownership of securities of the class that is subject to the bid within 90 days immediately preceding the offeror's bid, then the bid must meet certain criteria. Specifically, the bid's terms must be at least as favourable as the most favourable terms of any of those prior transactions, both in terms of the consideration offered and the percentage of the sellers' securities of the class for which the offer is made. If the highest consideration in the prior transactions was not solely in the form of cash, the consideration in the bid must be in the same form as that highest consideration or at least its cash equivalent.

However, the foregoing pre-bid integration rules do not apply to trades effected in the normal course on a published market, so long as:

1. no broker acting for the purchaser or seller performs services beyond the customary brokerage function, or receives more than reasonable fees or commissions;
2. the purchaser, or any person or company acting for the purchaser, does not solicit or arrange for the solicitation of offers to sell securities of the class subject to the bid; and
3. the seller or any person or company acting for the seller does not solicit or arrange for the solicitation of offers to buy securities of the class subject to the bid.[5]

5 MI 62-104, s. 2.6; OSA, s. 93.2; and Ont. Rule 62-504, ss. 2.3(1).

Trades that are matched in the "upstairs" market and completed through the facilities of a recognized stock exchange, do not meet the requirement of "normal course" purchases under the pre-bid integration rules.

The pre-bid integration rules do not apply to an acquisition of securities from the issuer of the securities, whether the securities previously had been unissued or acquired by the issuer.[6]

No public disclosure of pre-bid purchases is required under Canadian law unless the total number of securities of any class (including securities convertible into that class of securities) held by the buyer, and any person acting jointly or in concert with the buyer, constitutes 10% or more of the outstanding securities of that class.[7] However, where the class of securities of the Canadian target issuer is registered under the U.S. *Securities Exchange Act of 1934*, the buyer will be required to report its acquisitions to the SEC within 10 days of acquiring more than 5% of the outstanding securities of that class.

Purchases During the Bid

From the day of the announcement of the offeror's intention to make a formal take-over bid until the expiry of the bid, the offeror is prohibited from acquiring (or agreeing to acquire) beneficial ownership of securities of the target class, or securities convertible into securities of that class, other than under the bid itself,[8] unless certain conditions are met. These conditions include, among others:

1. the intention to make such purchases is stated in the take-over bid circular, or, if the intention changes after the date of the bid, that intention is stated in a news release issued and filed with the securities regulators at least one business day prior to the purchases;
2. the number of securities acquired outside of the bid does not exceed 5% of the outstanding securities of the target class as at the date of the bid;
3. the purchases are normal course, non-pre-arranged transactions on a published market; and
4. the offeror issues and files a press release containing prescribed information after the close of business on each day securities are purchased.[9]

The prohibition against acquisitions outside of the take-over bid does not apply to an agreement between a security holder and the offeror to the effect that the security holder will tender its securities to the take-over bid.[10]

Insider Trading

The insider trading provisions of securities legislation prohibit any person or company in a special relationship with a reporting issuer, from purchasing or selling securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed.[11]

A person or company in a special relationship with a reporting issuer includes an insider, affiliate or associate of a person or company that is proposing:

6 MI 62-104, ss. 2.4(2); OSA, ss. 93.2(3); and Ont. Rule 62-504, ss. 2.3(2).
7 MI 62-104, ss. 5.2(1); OSA, ss. 102.1(1); and Ont. Rule 62-504, s. 7.1.
8 MI 62-104, ss. 2.2(1); and OSA, ss. 93.1(1).
9 MI 62-104, ss. 2.2(3); OSA, ss. 93.1(5); and Ont. Rule 62-504, ss. 2.1(1).
10 MI 62-104, ss. 2.2(2); OSA, ss. 93.1(5); and Ont. Rule 62-504, ss. 2.1(2).
11 OSA, ss. 76(1); ASA, ss. 207(1); BCSA, ss. 86(1); and QSA, ss. 187 and 188.

1. to make a take-over bid for the securities of the reporting issuer; or
2. to become a party to a reorganization, amalgamation, merger or arrangement, or similar business combination with the reporting issuer, or to acquire a substantial portion of its property.[12]

Although it is difficult to precisely determine when a take-over bid is "proposed," as a result of the above, it is generally recommended that no purchases of shares in the target be made by the officers or directors of the offeror from the time a take-over bid is being considered.

In Quebec, there is a real issue as to whether an offeror may acquire a toe-hold without making use of insider information. Given the desire of the AMF to maintain a certain degree of harmony with the legislative framework of the other provinces, it will generally not intervene if the parties have no significant connection to Quebec. If the parties have a significant connection to Quebec, it is recommended that the proposed acquisition of securities be first discussed with the AMF.

Request for List of Security Holders

Securities law requires that the take-over bid circular be sent to all holders of the class of securities subject to the bid, as well as all holders of securities that are convertible into securities of the class which are subject to the bid (e.g. options). In order to accomplish this, it is necessary for the offeror to obtain a list of security holders of the target. The *Canada Business Corporations Act* ("CBCA"),[13] and Alberta's *Business Corporations Act* ("ABCA"),[14] require a corporation to provide such lists within 10 days after receipt of an affidavit[15] or statutory declaration,[16] respectively, containing the prescribed information. An offeror may be able to obtain the shareholders list in less time if the corporation is governed by British Columbia's *Business Corporations Act* ("BCBCA"),[17] since such statute states the list is to be furnished "promptly,"[18] or if the corporation was incorporated under Ontario's *Business Corporations Act* ("OBCA"),[19] which states that the list must be produced "as soon as is practicable."[20]

The delivery of this request will sometimes be the first notice to the target of the proposed bid. The courts have stated that the form of the affidavit or statutory declaration must be in strict compliance with the applicable legislation in order to be effective.[21] Accordingly, the contents of the affidavit or statutory declaration will be carefully reviewed by the target, and its counsel, to ensure compliance. If found to be defective, the affidavit or statutory declaration must be redelivered and the deadline to deliver the lists will start over.

More aggressive bidders have attempted to obtain the lists pursuant to the provisions of corporate law, which permit any person to examine the securities register upon payment of a reasonable fee and to make copies of those records.[22] The issue is whether option holders are covered by this provision. In at least one case,

12 OSA, s. 76(3); ASA, ss. 9(a); BCSA, ss. 86(3); and QSA, s. 189.
13 R.S., 1985, c. C-44.
14 R.S.A. 2000, c. B-9.
15 CBCA, ss. 21(3).
16 ABCA, ss. 23(5).
17 [SBC 2002] Chapter 57.
18 BCBCA, ss. 49(4).
19 R.S.O. 1990, Chapter B.16.
20 OBCA, ss. 146(2).
21 *Dylex Ltd. v. Mark's Work Wearhouse Ltd.* (1997), 38 B.L.R. (2d) 52 Alta. (Q.B.).
22 ABCA, ss. 23(4); CBCA, ss. 21(1); BCBCA, s. 46; and OBCA, s. 145. Under the CBCA (ss. 21(1.1)), and the BCBCA (s. 47), a person requesting such a list must provide an affidavit in the prescribed form.

an Alberta court has permitted the inspection of the records of the target, including the name and address of each holder of options, warrants, rights and securities convertible into common shares of the target.[23]

If there is no corporate statute that requires the target to provide a list of security holders to the bidder, as in the case where the target is an income trust, an offeror is still entitled to the list under securities legislation,[24] which, under this circumstance, substantially adopts the requirements of the CBCA.

Prohibition Against Collateral Agreements

As a general rule, an offeror in a take-over bid, and the offeror's joint actors, must not enter into an agreement or understanding that would have the effect of providing a security holder of the target with consideration of greater value than that offered to the other holders of the same class of securities (a "collateral benefit").[25] However, there are exceptions for benefits that are received by security holders solely in connection with their services as an employee, director or consultant of the target or of the successor to the business of the target, if certain conditions set out in the legislation are met.[26] It may also be possible to obtain from the securities regulators a discretionary exemption from the collateral benefit prohibition on the basis that the benefit would be conferred for reasons other than to increase the value of the consideration paid for securities acquired in the take-over bid.[27]

Defensive Tactics

Inadequate Disclosure and Misrepresentation

Once an unsolicited bid has commenced, the target will often engage in a series of defensive tactics to try to give its board of directors more time to adequately pursue all available alternatives. These tactics include a review of all actions taken by the bidder to ensure compliance with applicable law, such as compliance with the pre-bid integration rules. In addition, the target's corporate counsel will review the take-over bid circular for compliance with the disclosure requirements. Where the disclosure is found to be materially deficient, the target may make an application to the local securities regulatory authority to have the take-over bid cease traded. The commissions have entertained many applications based on allegations of non-compliance. Upon review of such decisions, it is clear that the deficiencies in the circular must be material. This position was clearly stated in *Re Standard Broadcasting Corp.* (1985), 8 OSCB 3672 at 3676-77:

> As to the allegations of inadequate disclosure that were made and did surface at several points during the course of the hearing, none were, in our respectful opinion, material in the sense that the disclosure asked for would have been necessary to allow an investor to make an informed investment decision. We stress this last point, as it is often the case that allegations of non-disclosure or inadequate disclosure, are made during the course of a take-over bid. There is a difference between perfect

23 See the order of the Court of Queen's Bench of Alberta dated May 25, 1999, in *Samson Canada Ltd. v. Highridge Exploration Ltd.* (unreported), Action Number 9901-07172 1999, in which the Court ordered compliance with ss. 21(4) of the ABCA, permitting the inspection of records of the target, including the name and address of each holder of options, warrants, rights and securities convertible into common shares of the target or any predecessor. No reasons for the decision were provided.

24 MI 62-104, s. 3.4; and OSA, s. 99.1.

25 MI 62-104, s. 2.24; and OSA, ss. 97.1(i).

26 MI 62-104, s. 2.25; OSA, ss. 97.1(2); and Ont. Rule 62-504, s.4.1.

27 MI 62-104, s. 6.2; and OSA, ss. 104(2)(a).

> disclosure (which no two opposing counsel likely would ever agree upon), acceptable disclosure and material non-disclosure or material misleading disclosure. In a case between these parties that was argued in the Supreme Court of Ontario before Madame Justice McKinlay after this Commission had denied relief, Madame Justice McKinlay noted that the appropriate standard of materiality is that set out in the judgment of the United States Supreme Court in *TSC Industries, Inc. et al v. Northway Inc.*, 426 U.S. 438, 96 5. Ct. 2126 (1976), which standard was approved by Montgomery, J. in *Royalty Trustco Ltd. et al. v. Campeau Corp. et al.* (1980), 31 O.R. (2d) 75 at 101 and by the Ontario Court of Appeal in *Sparling et al. v. Royal Trustco Ltd. et al.* (1984), 45 O.R. (2d) 484 at 490. That standard is:
>
> > "...an omitted fact is material if there is substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote...[or in deciding whether the tender his shares in the case of a take-over bid]..."
>
> No[t] one of the allegations of non-disclosure or inadequate disclosure met that standard of materiality. Although the *TSC Industries* standard of materiality often has been quoted and is well understood, it is frequently lost sight of when an allegation of non-disclosure is made before the Commission The fact that counsel for an applicant would have worded a matter differently, or would have made fuller disclosure, or would have placed emphasis on a different aspect of a matter, does not amount to non-disclosure unless there is a showing of materiality.

Even if the disclosure is found to be materially deficient, the securities commissions appear reluctant to cease trade an offer if the non-disclosure has been rectified through some other means. The most common means is through the directors' circular. The board of directors of the target is required to send to all shareholders a directors' circular within 15 days of the date of the bid. The statutory requirements of such circular impose upon the directors a statutory duty to rectify any deficiencies or material non-disclosure in a take-over bid circular. Accordingly, the commissions often take the position that any deficiencies in the take-over bid have been rectified by the directors' circular. An example of this can be found in *In the Matter of Rolland Inc. and Cascades Inc.* (1987), 10 OSCB 1629 at 1636:

> It must be noted, however, that Mr. Rolland's decision not to tender and the necessary result that the 90% acceptance condition, unless waived, could not be met, were forcefully and prominently stated in the Rolland directors' circular and, so stated and communicated, must be taken to be brought home to offerees. For that reason, and in all the circumstances of this case, we do not believe that Cascades' failure to disclose material information in its take-over bid circular should, by itself, lead us to make the requested cease trade order.

This position was also supported in *Canfor Corporation and Slocan Forest Products Ltd.* (1995), 18 OSCB 475 at 481-2, where the OSC stated:

> We have some doubt as to whether the correction of serious disclosure deficiencies in a take-over bid circular by appropriate disclosure in the directors' circular would in all circumstances suffice to remedy the situation. However, in this case the Slocan directors did make appropriate disclosure in their circulars of the matters which we have found should have been, but were not, disclosed in the Canfor offering documents, and the deficiencies in the latter were, in our view, while material, not so significant as to demand and order correcting them in the circumstances. In addition, the directors of Slocan disclosed the omitted information in sufficient time to allow the Slocan shareholders to make a reasoned decision as to the desirability of accepting the Canfor bid.

Poison Pills

Many Canadian public companies have adopted a shareholder rights plan ("SRP") or "poison pill." If the target has an SRP, the offeror will need to carefully review it.

The normal stated purposes of an SRP in Canada are to ensure that all shareholders are treated equally and to provide a period longer than 35 days for the board of the target to develop an alternative to maximize shareholder value. An SRP must be approved by a majority of the shareholders within six months of its adoption by the board of directors or the SRP is terminated.[28] Prior to adopting an SRP, the issuer will often submit the draft plan to RiskMetrics Group. This organization focuses on corporate governance issues and will issue a voting recommendation on the SRP. Many Canadian institutional investors will vote against the SRP if RiskMetrics Group issues a negative recommendation.

SRPs would normally be triggered by a person becoming an "acquiring person," which is generally defined as the beneficial owner of a specified percentage (usually 20%) of the outstanding voting securities of the company. A buyer can prevent the triggering of the SRP by making a "permitted bid," which typically is a bid that is open for a minimum period (usually 60 days), requires as a condition of the bid that a minimum of 50% of the shares held by independent shareholders be deposited, and if the minimum is achieved, the bid be extended for at least 10 days to give the remaining shareholders an opportunity to accept the bid.

In 1997, a Manitoba court held that a bidder had triggered the target's SRP when it entered into a lock-up agreement with a significant shareholder (under which the shareholder agreed to tender its shares to the proposed bid)[29]. Since this decision, SRP's have generally excluded a "permitted lock-up agreement" from the definition of "beneficially owned" shares, so that the execution of a lock-up agreement will not trigger the SRP.

28 Toronto Stock Exchange Company Manual, s. 636(a); and TSX Venture Exchange Corporate Finance Manual, Policy 3.1, s. 12.3.
29 *United Grain Growers Ltd. v. 3339351 Canada Ltd.* (1997) 32 B.L.R. (2d) 132.

In the U.S., a proxy contest is often an important part of the take-over battle, since obtaining control of the board may be essential in order to dismantle the poison pill. This is not the case in Canada, where it has been common practice for the offeror to make application to a securities commission to have the target's SRP cease traded, resulting in numerous commission decisions on the subject.

The decision in *Re Royal Host Real Estate Investment Trust and Canadian Hotel Income Properties Real Estate Investment Trust* (1999), 22 OSCB 7819, is of particular significance since it was a decision of three of the major provincial securities commissions (British Columbia, Alberta and Ontario). In that case, the commissions attempted to reconcile various prior decisions. They indicated that there was no comprehensive and conclusive test that was required to be met. Instead, a commission must consider all of the relevant factors of the particular case when deciding whether or not to cease trade the SRP. The decision then went on to state at page 7828:

While it would be impossible to set out a list of all of the factors that might be relevant in cases of this kind, they frequently include:

- whether shareholder approval of the rights plan was obtained
- when the plan was adopted
- whether there is broad shareholder support for the continued operation of the plan
- the size and complexity of the target company
- the other defensive tactics, if any, implemented by the target company
- the number of potential, viable offerors
- the steps taken by the target company to find an alternative bid or transaction that would be better for the shareholders
- the likelihood that, if given further time, the target company will be able to find a better bid or transaction
- the nature of the bid, including whether it is coercive or unfair to the shareholders of the target company
- the length of time since the bid was announced and made
- the likelihood that the bid will not be extended if the rights plan is not terminated

In considering these factors in the hearings, the question that the Canadian securities commissions consistently addressed until 2007, was not "if" an SRP should be set aside, but rather "when" was it time for the SRP to go. The commissions had repeatedly stated that once the SRP had served the purpose of providing the board with adequate time to pursue alternatives, the pill had to be set aside and the commissions would intervene and cease trade the SRP.[30]

In a significant shift in policy in 2007, the Alberta Securities Commission allowed an SRP, that was approved by the target's shareholders during a hostile take-over bid, to remain in place and prevent the hostile bid from being completed.[31] The Ontario Securities Commission made a similar decision in 2009.[32] However, in a subsequent decision, the British Columbia Securities Commission refused to depart from the historical

30 *Re Canadian Jorex Ltd. and Mannville Oil & Gas Ltd.* (1992), 15 OSCB 257; and *Re MDC Corporation and Regal Greetings & Gifts Inc.* (1994), 17 OSCB 4971.
31 *Re Pulse Data Inc.*, 2007 ABASC 895.
32 *Re Neo Material Technologies Inc. and Pala Investments Holdings Limited* (2009), 32 OSCB 6941.

position of the securities commissions that the only acceptable use of an SRP during a hostile take-over bid is to assist the target's board in attempting to obtain an alternative transaction for shareholders.[33]

As a result of these conflicting decisions, there is currently a discrepancy among Canadian securities regulators in the manner that they view poison pills. Accordingly, since a securities regulatory hearing on a poison pill normally takes place in the province or territory of the target's head office, the target's location could determine the outcome of the hearing. Nevertheless, it is clear at the present time in Canada that if there is no vote of shareholders approving a poison pill during the hostile take-over bid, the position of the regulators is that the poison pill will not be permitted to impede the bid indefinitely, regardless of where the target is located.[34]

Obtaining the Balance of the Shares

Compulsory Acquisition

The compulsory acquisition provisions are contained in the corporate legislation of the jurisdiction in which the target is incorporated. However, in the case of an income trust or royalty trust, the compulsory acquisition right may not be available if such right is not contained in the declaration of trust which created the trust.

The compulsory acquisition procedures generally state that, if within 120 days after the date of a take-over bid the bid is accepted by the holders of not less than 90% of the shares of the class to which the take-over bid relates (other than shares held at the date of the bid by or on behalf of the offeror or an affiliate or associate of the offeror), the offeror is entitled, on complying with the procedures set out in the applicable corporate legislation, to acquire the shares held by those holders who did not tender to the take-over bid.[35] This right must generally be exercised within 60 days after the termination of the bid, and in any event, within 180 days after the date of the take-over bid (although the time limits are not identical in all the Canadian jurisdictions).[36] The amount paid for the remaining shares under these provisions will either be the same consideration that was paid for the shares purchased under the bid or, if the shareholder demands payment of the fair value of the shares, the amount as determined by the applicable court.

Second Step Transaction

When the offeror acquires less than 90% of the outstanding shares it did not hold prior to the commencement of the bid, the offeror will need to complete a subsequent acquisition transaction in order to acquire the remaining securities. A "going private" transaction is generally defined in corporate legislation as an amalgamation, arrangement, consolidation or other transaction in which a holder of a participating security (a security that carries a right to participate in the earnings of the issuer and, upon the liquidation or winding up of the issuer, in its assets) can be required, without the holder's consent, to surrender the security, without the substitution of another participating security of equivalent value in the corporation or a successor to the corporation. However, a "business combination," as defined in Multilateral Instrument 61-101 ("MI 61-101"), which is in force in Ontario and Quebec, is much broader than the historical definition found in the corporate legislation. In MI 61-101, a business combination is defined as:

33 *Re Icahn Partners LP and Lions Gate Entertainment Corp., 2010 BCSECCOM 233.*
34 For the Ontario Securities Commission, this was confirmed in *Re Baffinland Iron Mines Corporation* (2010) 33 OSCB 11385.
35 CBCA, ss. 206(2); ABCA, ss. 195(2); OBCA, ss. 188(1); BCBCA, s. 300; and QBCA, ss. 149(5).
36 CBCA, ss. 206(3); ABCA, ss. 196(1); OBCA, ss. 188(2); BCBCA, ss. 300(3) (the time limit under the BCBCA is within five months after making the bid); and QBCA, ss. 149(1).

> an amalgamation, arrangement, consolidation, amendment to the terms of a class of equity securities or any other transaction of the issuer, as a consequence of which the interest of a holder of an equity security of the issuer may be terminated without the holder's consent regardless of whether the equity security is replaced with another security, but does not include...[37]

A "related party" includes a person or company that beneficially owns or exercises control or direction over voting securities of the issuer carrying more than 10% of the voting rights attached to all outstanding voting securities of the issuer. As a result, any second step transaction by the offeror will be considered a business combination under MI 61-101.

MI 61-101 generally requires that a corporation proposing to carry out a business combination disclose the following in the information circular sent to shareholders:

1. every prior valuation in respect of the issuer which has been made in the 24 months before the date of the information circular and which was known to the issuer or any director or senior officer of the issuer; and
2. any bona fide prior offer which was received by the issuer during the 24 months before the transaction was agreed to.

Unless an exemption is available, MI 61-101 also requires the preparation of an independent valuation of the target company's shares (and, subject to certain exceptions, any non-cash consideration being offered therefor). An exemption from this requirement applies if:

1. the business combination is being effected by the same buyer that made a take-over bid (or by an affiliate of that buyer) and is in respect of the same class of securities that were the subject of the bid;
2. the business combination is completed no later than 120 days after the date of expiry of the take-over bid;
3. the intent to effect a business combination was disclosed in the take-overbid circular;
4. the consideration per security paid in the business combination is at least equal in value and in the same form as the consideration that was paid in take-over bid; and
5. the take-over bid circular described certain tax consequences of both the take-over bid and the subsequent business combination.

MI 61-101 also requires that, in addition to any other required shareholder approval, the approval of the "minority" holders of the target shares be obtained at the meeting. Shares tendered to a take-over bid (including shares which were tendered pursuant to a lock-up agreement) may be voted by the offeror in the subsequent acquisition transaction, if, among other things, the above criteria are met and if the shareholder who tendered such shares was treated the same as all other shareholders (i.e. the per-share consideration received by the holder was identical in value and in form as received by the other holders, and the holder received no other consideration or collateral benefit for tendering such shares).

37 S. 1.1.

Plan of Arrangement

A plan of arrangement is a multi-step transaction which may involve an amalgamation, an amendment to the corporation's articles, a transfer of property, an exchange of securities, a compromise with creditors or any combination of the above. The principal disclosure document is the information circular which is mailed to the target's security holders in respect of the meeting called to approve the arrangement.

A plan of arrangement involves two court appearances and a shareholders meeting. At the first court appearance, the parties request an interim order which provides for the calling of a special meeting of shareholders and sets out procedural matters, such as the determination of the classes which have the right to vote separately as a class and the percentage of approval required. The court will also ensure that shareholders are granted a dissent and appraisal right similar to the one they would have received if the corporation had proposed an amalgamation. At the second court appearance, which occurs after the shareholders meeting, the court is asked to issue a final order approving the plan of arrangement. Shareholders who object to the granting of the order may attend and present evidence at this hearing. In determining whether to grant the requested order, the court will consider whether the plan is "fair" to the shareholders. The court may approve the arrangement as proposed or as amended by the court. The plan of arrangement becomes effective once the necessary documents, which include the final order, are filed with the applicable corporate registry and, in certain circumstances, a certificate is issued by the corporate registrar.

Subsection 3(a)(10) of the U.S. *Securities Act of 1933* (the "1933 Act") provides an exemption from the registration requirement for the issuance of securities (if the issuance has been approved by a court of competent jurisdiction after a hearing on the fairness of the terms and conditions of issuance, of which all holders of the target's securities receive notice, and have an opportunity to attend and be heard). Canadian plans of arrangement have been expressly recognized by the SEC as satisfying the requirements of ss. 3(a)(10). As a result, the plan of arrangement is often used if a Canadian target has a significant number of U.S. shareholders, since it enables the buyer to issue its securities to the shareholders of the target pursuant to the plan of arrangement, without prior SEC review. In addition, Canadian foreign private issuers are exempt from the SEC proxy rules. Therefore, if a U.S. buyer's shareholders are not required to vote on the transaction, the SEC proxy rules will also not apply.

Depending on the issuer's jurisdiction of incorporation, an issuer proposing a plan of arrangement may be required to demonstrate to the court that it is "not practicable" to effect the proposal under any other provision of the incorporating statute. Where the proposed arrangement has consisted of nothing more than a share exchange or amalgamation, issuers have convinced Canadian courts that the inability to rely on ss. 3(a)(10) of the 1933 Act, with the resulting expense and time delay required to clear a registration statement, makes the other provisions of the incorporating statute "not practicable."

Advantages and Disadvantages

A plan of arrangement has a number of advantages. Firstly, it offers maximum structuring flexibility and may accommodate the needs of numerous classes of security holders. Another major advantage is that the offeror may acquire 100% of the target upon obtaining the approval of only two-thirds of the votes of each class of securities that are entitled to be voted at the meeting. Accordingly, there is no need for a "second step" transaction. Thirdly, the information circular with respect to the meeting does not generally need to be translated into French. Finally, most of the restrictive take-over bid rules, including the pre-integration rules and the collateral benefit rules, do not apply to a plan of arrangement (although persons receiving collateral benefits may, depending on the circumstances, be precluded from voting in a "minority approval" vote that securities regulations may require).

Disadvantages of the arrangement structure include the longer time frame (usually 60 days or longer if an exchangeable share structure is used) and the increased cost. In addition, even if the transaction is approved by the required percentage of shareholders, there is no guarantee that the transaction will be approved by the court, since a shareholder may appear before the court and argue that the transaction is not fair. Finally, a plan of arrangement may only generally be used in a friendly situation.

In a plan of arrangement, the terms of the transaction are normally negotiated between management of the target company and the buyer, and are set out in an acquisition or pre-acquisition agreement. This agreement is the contract that sets out the ground rules under which the transaction is proposed to be completed. The agreement sets out such matters as the consideration to be offered, the conditions precedent to the arrangement, and the representations and warranties of the target. The agreement will also deal with any existing shareholder rights plan. Perhaps the most contentious parts of the agreement relate to the scope of the "no shop" clause, the existence and amount of any break fees, and the terms of any required lock-up agreements from management.

When shares of a buyer form all or part of the consideration, the plan of arrangement is often structured as a three-cornered amalgamation in which the target company amalgamates with a subsidiary of the buyer (which has been incorporated for this purpose), pursuant to which the shareholders of the target receive shares of the buyer. This structure alleviates the need for the buyer to obtain the approval of its shareholders, provided that this approval is not required by a stock market on which the buyer's securities are listed. (For example, certain stock markets in the U.S. require shareholder approval if a listed company proposes to issue a number of shares exceeding 20% of its outstanding shares in an acquisition transaction, including a plan of arrangement.)

Exchangeable Share Transactions

Exchangeable share transactions are used commonly in plans of arrangement involving a Canadian target and a foreign buyer. The purpose of this structure is to provide Canadian resident shareholders of the target with a tax-deferred rollover on the exchange of their shares of the target company, for shares of a Canadian acquisition company that are exchangeable at the holder's option for common stock of the foreign public parent. The target's outstanding options are also usually replaced pursuant to the arrangement, with replacement options exercisable into exchangeable shares. In this structure, the shareholder's capital gain is deferred until the shareholder sells the exchangeable shares or exercises the exchange right, and acquires the publicly traded shares of the foreign parent company. In addition, the Canadian shareholder will receive the Canadian dividend tax credit on any dividends declared on the exchangeable shares. Exchangeable shares are normally subject to a forced exchange after a certain period of time (usually 5-10 years).

Exchangeable shares are structured to be, in essence, the economic equivalent of the foreign parent issuer's common stock. The exchangeable shares carry a right to receive dividends on a per-share-equivalent basis in amounts (or property in the case of non-cash dividends) which are the same as, and which are payable at the same time as, dividends declared on the buyer's common stock. The exchangeable shares carry a right to vote on a per-share-equivalent basis at all shareholder meetings, at which holders of the buyer's common shares are entitled to vote, usually through the medium of a special voting share in the capital of the buyer, carrying votes equal to the number of outstanding exchangeable shares. Exchangeable shares also carry the right to participate on a per-share-equivalent basis to that of the buyer's common stock in a liquidation, dissolution or other winding up of the buyer, or distribution of any assets of the buyer.

The terms of the exchangeable shares are established through a combination of documents, including the share provisions, a support agreement which provides covenants of the buyer to provide the necessary financial support to allow the Canadian subsidiary to declare dividends equivalent to those declared by the buyer, and a voting and exchange trust agreement which provides covenants of the buyer concerning the voting and exchange mechanics.

Exchangeable share transactions are usually done through a plan of arrangement and follow one of the following structures:

1. the buyer organizes a Canadian subsidiary and the Canadian shareholders exchange their shares in the target company for exchangeable shares of the foreign buyer's Canadian subsidiary;
2. a three-cornered amalgamation in which the target company amalgamates with a subsidiary of a foreign buyer that has been incorporated for this purpose, pursuant to which the shareholders resident in Canada receive exchangeable shares of the amalgamated company which are exchangeable into shares of the buyer; or
3. the target company undergoes a capital reorganization in which the common shares of the target company are converted into exchangeable shares of the target company.

The buyer may need shareholder approval to create a new class of shares, since in many exchangeable share transactions, a single "special voting share" is issued to the trustee and the voting rights of the holders of exchangeable shares are exercised through that special voting share.

Exchangeable shares issued in an arrangement involving a U.S. buyer are freely transferable under U.S. federal securities laws, except exchangeable shares which are held by persons who are deemed to be "affiliates" (as defined in the 1933 Act) of the target and buyer prior to the transaction, which shares may be resold by them only in transactions permitted by the resale provisions of Rule 145 under the 1933 Act, or as otherwise permitted under the 1933 Act. The buyer will file a registration statement prior to the effective time of the arrangement in order to register under the 1933 Act the issuance, from time to time, of the foreign parent's common shares in exchange for the exchangeable shares. It is often a condition for completion of the arrangement that the registration statement be declared effective by the SEC. The buyer also usually agrees to file a registration statement in order to register under the 1933 Act the issuance of its common shares, from time to time, after the effective date of the arrangement upon the exercise of any replacement options issued to replace the options of the target.

When a Canadian reporting issuer amalgamates with another company, the amalgamated company automatically becomes a reporting issuer in the same Canadian jurisdictions. The shares issued pursuant to the amalgamation are freely tradable if any amalgamating company has been a Canadian reporting issuer for at least four months. The result is similar in the case of an arrangement. For exchangeable shares, there is an exemption that relieves the issuer of the exchangeable shares from the continuous reporting requirements that normally apply to reporting issuers under Canadian securities laws. The exemption is subject to conditions relating to the dissemination of information regarding the foreign parent company. The effect of those conditions is to provide the holders of exchangeable shares with annual and interim consolidated financial statements, and other information regarding the foreign parent company, in lieu of financial statements and continuous disclosure documents of the issuer of the exchangeable shares.

Conclusion

Determining the best method of acquiring a Canadian public company will always depend on the particular circumstances, having regard to securities-related considerations and other factors. The choice will usually be between a take-over bid and a plan of arrangement, and there are advantages and disadvantages to each. In the case of an unsolicited or hostile transaction, a take-over bid will generally be the only option.

There are a number of features of Canadian securities law that are unique internationally, and this is particularly the case in the area of mergers and acquisitions. Of special note is the approach of the Canadian securities regulators with respect to take-over defensive tactics, which has not been entirely consistent among the provincial jurisdictions.

The Securities Group at Fraser Milner Casgrain LLP includes professionals with substantial experience, both as practitioners and regulators. We understand not only the black letter laws, but also the approach regulators take in applying those laws. This requires continuous monitoring of the regulatory changes that are taking place among the various provinces and territories of Canada. Armed with this knowledge, in combination with our considerable experience in acting for buyers and targets in both friendly and hostile situations, we are well positioned to provide clients with innovative strategies to accomplish their objectives, regardless of the complexity of the issues confronting them in an acquisition transaction.

Tax Considerations – General Overview of Canadian Income Tax Principles

Introduction

Tax considerations are always critical in any acquisition transaction. This discussion provides an overview of the relevant Canadian tax considerations (including federal and provincial income, commodity and payroll taxes) which must be reviewed by a non-Canadian resident considering the acquisition of a Canadian business. Although the comments in this section focus on an acquisition by a U.S. resident, they are generally applicable to all non-Canadian residents.

Federal Income Taxes

Canada imposes tax on residents of Canada on their worldwide income determined under its *Income Tax Act*[38] (the "Act"). Taxable income includes employment income, business profits, and investment income such as dividends, interest and capital gains (net of capital losses) from the disposition of capital property.

In contrast, non-residents are only subject to income tax on taxable income earned in Canada in respect of employment income earned in Canada, income from a business carried on in Canada and gains from the disposition of "taxable Canadian property." The definition in the Act of "carrying on business" in Canada is very broad and includes soliciting orders or offering anything for sale in Canada through an agent or servant, whether the contract or transaction is completed inside or outside Canada. "Taxable Canadian property" includes: (a) real property situated in Canada; (b) property held or used in carrying on a business in Canada; (c) shares and interests in corporations, trusts and partnerships (whether Canadian or non-Canadian) which are not publically listed, if at any time in the 60 months before the disposition, more than 50% of the fair market value of the shares or interests was derived from Canadian real estate, Canadian resource properties, Canadian timber resource properties and options in such properties; and (d) in the case of certain publically listed shares and interests, in addition to meeting the 50% test set out in (e), at any time in the 60 months before the disposition, the owner of the shares or interests along with non-arm's length persons must have owned more than 25% of a class of shares of the corporation or interests in trusts or partnerships. Canada also imposes a non-resident withholding tax on certain dividends, royalties, management and administration fees, rent, interest and certain other payments paid or credited by a Canadian resident (and certain non-residents subject to Canadian tax) to a non-resident (please see "Withholding Taxes" below). As discussed below, the tax imposed on non-residents may be reduced or eliminated under an applicable tax treaty.

Provincial Income Taxes

Each of the Canadian provinces and territories also imposes income tax on residents of that province or territory that are individuals, estates or trusts. The income tax is typically a percentage of the federal tax payable. However, Quebec uses its own formula which closely follows the federal one.

A provincial or territorial tax is also imposed on both corporations incorporated in Canada and non-resident corporations that carry on business through an establishment in a province or territory. The computation of

38 (1985, c.1 (5th Supp.)).

taxable income of the corporation is determined in a manner similar to the federal rules. The allocation of income among most of the provinces and territories is based on rules contained in the *Income Tax Regulations*.[39] However, Quebec and Alberta allocate income based on their own provincial rules.

Commodity Taxes and Payroll Taxes

In addition to income taxes and capital taxes, both goods and services are taxed in Canada. For the most part, a consumption tax is levied at both the federal and provincial levels, although some provinces levy this tax through a harmonized structure. The federal sales tax is presently 5% and is called the goods and services tax (the "GST"). Ontario's and British Columbia's sales taxes, 8% and 7% respectively, are "harmonized" with the GST (the "HST") although it should be noted that BC taxpayers have recently voted to rescind the BC HST and return to a provincial sales tax (the "PST") system. Quebec levies a sales tax of 8.5% (the "QST") which is very similar to the GST. It should be noted that the GST, the Ontario and British Columbia HST, and the QST, are "value added taxes" and are generally refunded to most commercial operations. In addition, most goods exported from Canada are not subject to the GST, HST or QST.

Commercial entities that are involved in making taxable supplies in Canada, including non-residents of Canada who are making supplies in the course of a business carried on in Canada, are required to register for and charge, collect, and remit GST, HST and QST, where applicable, on such supplies.

Currently, the provinces of Saskatchewan, Manitoba and Prince Edward Island impose a PST which is a single incidence sales tax imposed on end-users of tangible personal property as well as certain services in the province. The PST varies from 5% in Saskatchewan to 7% in Manitoba and 10% in Prince Edward Island. The province of Alberta does not impose a separate sales tax.

Most provinces also levy a tax when land is transferred. In addition there are several payroll taxes imposed by the federal and provincial governments including employment insurance, Canada Pension Plan (which in Quebec is replaced by the Quebec Pension Plan) and provincial health taxes.

Accordingly, in connection with any transaction, income, commodity and payroll tax advice should be obtained.

Federal and Provincial Income Tax Rates

This discussion focuses on resident and non-resident Canadian corporations. The 2011 combined federal and provincial corporate income tax rates on taxable business income allocable to a permanent establishment in a province generally range between 26.5% to 32.5% (a lower rate of tax is available on a portion of the taxable active business income earned by Canadian-controlled private corporations). Based on the present provisions of the Act, the tax rate will be reduced by 1% in 2012.

It should be noted that Canada does not permit corporations to use consolidation in determining their taxable income. In other words, each entity must determine its own taxable income (or losses) and is subject to tax on this basis. Therefore, losses of one corporation cannot offset the profit of a related corporation. However, in the 2010 federal budget, the government announced that it was seriously considering a change to the Canadian tax system which would permit consolidation.

39 (C.R.C., c.945).

Withholding Taxes

Canada imposes a withholding tax at a rate of 25% on non-residents who receive from Canadian residents and certain non-Canadian residents, various types of income from property including certain dividends, royalties, management and administration fees, rent and interest payments. However, in respect of interest, the Act provides that interest (which is not participating interest) paid to an arm's length creditor is not subject to withholding tax. The rate of withholding tax may be reduced by a tax treaty entered into by Canada and the country in which the recipient is resident, if the recipient is entitled to the benefits of the treaty. For example, the rate of withholding tax is reduced to 15% (or 5% in certain circumstances) with respect to dividends under the *Canada-United States Income Tax Convention* (the "Treaty") for U.S. residents who can benefit from the Treaty.

In addition, the Treaty stipulates that there is no withholding tax payable in respect of all interest payments (including non-arm's length interest payments) which are not participating interest payments, as defined in the Treaty.

The Canadian resident payor of any amount subject to withholding tax is liable for withholding and remitting this tax on behalf of the non-resident recipient. In addition, certain payments to a non-resident person by another non-resident person whose business is carried on in Canada may be subject to Canadian withholding taxes to the extent that the payments are deductible in computing the payor's taxable income earned in Canada.

Payments made by a Canadian subsidiary for products purchased from its non-resident parent company will generally not be subject to Canadian withholding tax, provided that the products are purchased under terms and conditions that are comparable to arm's length transactions. If the inter-company prices diverge from arm's length prices, any discrepancies could be subject to Canadian withholding taxes and may also give rise to other Canadian income tax consequences (please see "Transfer Pricing Rules" below).

Branch Taxes

In addition to the tax payable in respect of income from a business carried on in Canada, a non-resident corporation which carries on business in Canada directly (as contrasted to carrying on business through a Canadian subsidiary) is subject to a tax in respect of after-tax branch profits of the corporation which are remitted outside of Canada. This tax is commonly referred to as a "branch tax" and is a rough equivalent to the withholding tax which would be payable on any dividends paid by a Canadian subsidiary to its foreign parent corporation.

Branch tax is payable at a rate of 25% on the after-tax profits of the branch operation in excess of the corporation's investment allowance, but is reduced to the treaty rate on dividends paid by a corporation resident in Canada to a non-resident corporation that owns all the shares of the Canadian corporation. For example, under the Treaty, the rate of branch tax is reduced to 5% for U.S. residents who can benefit from the Treaty. In addition, the Treaty eliminates the branch tax on the first $500,000 of income subject to branch tax.

The "investment allowance" represents the accumulated after-tax profits that the corporation has re-invested in its Canadian branch operations. It is calculated based on the assets and liabilities of the branch. Debt will reduce the corporation's investment allowance for branch tax purposes if the interest on such debt is deductible by the corporation in computing branch profits, or would be deductible but for certain interest deductibility restrictions. The investment allowance is re-calculated at the end of each year. The amount deducted in computing branch profits for a particular year is added back into the branch tax base in the immediately following year. This method of calculating the branch tax base ensures that the tax is payable on after-tax profits of the branch that are not re-invested into the Canadian branch operations.

Capital Taxes

The federal government phased out the “large corporation tax” effective for the 2006 and later taxation years. This was essentially a tax that was imposed on the capital employed in Canada by a corporation. All provinces have announced the elimination of their capital taxes on most corporations other than financial institutions. Some provinces, including Ontario, Alberta and British Columbia, do not currently impose a capital tax on most corporations. It should be noted that financial institutions are subject to specific rules relating to federal and provincial capital taxes.

Transfer Pricing Rules

Transfer pricing refers to the prices charged for goods and services and the use of property (including intangible property) to or by a non-resident related party. Canada’s transfer pricing rules are found in section 247 of the Act. Many other countries, including the U.S., have similar transfer pricing rules in their domestic tax law.

The transfer pricing rules embody the arm’s length principle, which is endorsed by the Organization for Economic Co-operation and Development (“OECD”). This principle requires taxpayers to determine their income tax consequences in respect of virtually all transactions with non-arm’s length parties based on arm’s length terms and conditions. The rules are intended to prevent multinational corporations from shifting profits out of Canada by charging prices for intra-group transfers of property, or use of property and provision of services that deviate from arm’s length prices.

The transfer pricing rules apply where a taxpayer (or a partnership) and a non-resident person with whom the taxpayer (or partnership, or a member of the partnership) does not deal at arm’s length, are participants in a transaction or a series of transactions, and:

1. the terms and conditions made or imposed in respect of the transaction or series between any of the participants in the transaction or series, differ from those that would have been made between persons dealing at arm’s length; or
2. the transaction or series would not have been entered into between persons dealing at arm’s length, and can reasonably be considered not to have been entered into primarily for bona fide purposes, other than to obtain a tax benefit.

If the transfer rules apply, the Act provides a recharacterization so that:

a. in the case of the first condition, the transaction or series is deemed to occur under terms and conditions that would have been entered into between arm’s length parties; and
b. in the case of the second condition, the transaction or series is deemed to be a transaction or series that would have been entered into between arm’s length parties.

In addition to the adjustments to arm's length prices, a taxpayer will be subject to a penalty under subsection 247(3) of the Act where the deviation from arm's length amounts is greater than CDN$5M, or 10% of the taxpayer's gross revenue for the year, whichever is less. The penalty is essentially equal to 10% of the adjustment to the arm's length amounts.

Generally, a taxpayer will avoid the penalty where the taxpayer, or the partnership of which the taxpayer is a member, makes a reasonable effort to determine and use arm's length prices or allocations. The taxpayer or the partnership is deemed not to have made a reasonable effort to determine and use arm's length transfer prices or allocations in respect of a transaction or series, unless the taxpayer or the partnership complies with certain requirements to maintain contemporaneous transfer pricing reports to support the determination of arm's length prices and allocations.

A large part of determining the appropriate arm's length prices and preparing contemporaneous documentation is identifying comparable arm's length transactions and obtaining relevant information about such transactions. The OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "OECD Guidelines") outline a number of factors which may influence the degree of comparability of the transactions in question. These factors include:

1. the characteristics of the property or service being purchased or sold;
2. the functions performed by the parties to the transactions;
3. the terms and conditions of the contract;
4. the economic circumstances of the parties; and
5. the business strategies pursued by the parties.

Over the years, various methods have been accepted by tax authorities in determining whether the prices or other amounts used by the taxpayer are arm's length amounts. The methods are divided into two groups: the traditional transaction method and the transactional profit method. The traditional transaction method includes the comparable uncontrolled price ("CUP") method, the resale price method and the cost-plus method. The transactional profit method includes the profit-split method and the transactional net-margin method ("TNMM"). According to the Canada Revenue Agency (the "CRA"), the federal agency that administers the income tax law for the Government of Canada and most provinces and territories, "traditional transaction methods are the most reliable means of establishing arm's length prices or allocations." (See *Information Circular*, IC 87-2R, entitled "International Transfer Pricing," dated September 27, 1999 (http://www.cra-arc.gc.ca/menu/ICSC-e.html), in which the CRA provides its views on the topic of transfer pricing).

It should be noted that a transfer pricing dispute involving a corporation which is resident in a country with which Canada has entered into a tax treaty, and which is entitled to the benefits of such treaty, may be settled by the Competent Authority of Canada and the treaty jurisdiction, as set out in the mutual agreement procedure provision of the relevant tax treaty. Alternatively, a taxpayer can appeal a CRA transfer pricing determination to the Tax Court of Canada (the "TCC") and if unsuccessful at the TCC to the Federal Court of Appeal, and then with leave to the Supreme Court of Canada.

Canada-U.S. Tax Treaty[40]

The application of Canadian income tax in accordance with the Act is subject to the provisions of any tax treaty entered into between Canada and another country or jurisdiction. Canada has entered into many tax treaties and a complete list of the tax treaties in force is available on the Department of Finance Canada website (see http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp).

The purpose of the Treaty (and all other tax treaties) is to prevent the double taxation of income which arises because each country asserts its authority to tax its residents, as well as any income derived by non-residents, from sources within the country. Like other tax treaties, the Treaty generally recognizes a country's prerogative to tax its own residents and minimizes the incidence of double taxation by limiting the source country's jurisdiction to tax the residents of the other country.

Treaty Relief

The Treaty contains relief provisions for income tax, withholding tax, branch tax on business profits, as well as various types of investment income. However, as noted below under the section "Limitation on Benefits Provision," it contains a limitation on benefits provision which may restrict the ability of certain U.S. resident entities from benefiting from its provisions.

Business Profits

Article VII of the Treaty limits Canada's jurisdiction to tax the business profits of a U.S. corporation that are attributable to a permanent establishment (as defined in the Treaty) situated in Canada. Accordingly, business profits that are not attributable to a permanent establishment situated in Canada are not subject to Canadian income taxes. In this regard, business profits include income from a business, as well as other types of income that do not fall within other categories of income recognized by the Treaty. For instance, as noted above under the section "Withholding Taxes," the payment of certain management and administration fees is subject to withholding tax at the domestic withholding tax rate of 25%. However, Article VII of the Treaty will normally permit a full exemption for such fees paid to a resident of the U.S. who can benefit from the Treaty, provided that the fees are not business profits attributable to a permanent establishment situated in Canada and that the fees are reasonable.

The definition of "permanent establishment" under Article V of the Treaty includes branches, offices, agencies and other fixed places of business of a U.S. corporation. However, a place of business used solely for the purpose of storage, display or delivery of goods belonging to the U.S. resident, or used solely for the purchase of goods, the collection of certain information and advertising, is excluded from the definition of "permanent establishment."

A "permanent establishment" of a U.S. resident also includes an agent (other than an agent of an independent status), if such person has, and habitually exercises in Canada, an authority to conclude contracts in the name of the U.S. resident. A U.S. resident will not be deemed to have a permanent establishment in Canada merely because such resident has a broker, general commission agent or any other agent of an independent status in Canada.

40 This discussion focuses on the Treaty. However, many comments with respect to the Treaty are applicable to tax treaties between Canada and other countries.

In addition, a permanent establishment will be deemed to exist in Canada for: (a) an individual who performs services in Canada, is present for more than 182 days in Canada in any 12-month period, and more than 50% of the gross active business revenue of the enterprise consists of income derived from the services performed in Canada by the individual; and (b) any person providing services, if the services are provided in Canada for an aggregate of more than 182 days in any 12-month period with respect to the same or a connected project for customers who are either residents of Canada or who maintain a permanent establishment in Canada, and whose services are provided in respect of that permanent establishment.

Dividends

Article X of the Treaty limits the rate of withholding tax that can be imposed on payments of dividends to a resident of the U.S. which qualifies for Treaty benefits to 15%. In addition, paragraph 2 of this Article provides that if a U.S. corporation beneficially owns at least 10% of the voting stock of a Canadian corporation, dividends paid by the Canadian corporation to the U.S. corporation will be subject to a 5% withholding tax rate.

Interest

The rate of withholding tax that can be imposed on payments of interest to a resident of the U.S. is governed by Article XI of the Treaty. However, as noted above, effective January 1, 2008, the Act was amended to eliminate withholding tax on interest paid by a Canadian resident to an arm's length person resident in any country, so long as such interest is not "participating debt interest." In addition, the Treaty eliminates withholding tax on most interest paid to non-related U.S. residents, including interest paid to a non-arm's length U.S. person) so long as such interest is not a form of participating interest, as defined in the Treaty. It should be noted that the definition of "participating interest" in the Act is different than that found in the Treaty. Interestingly, no other Canadian tax treaty has a similar provision relating to non-arm's length interest payments.

Branch Tax Relief

The Treaty also reduces the rate of branch tax on non-resident corporations carrying on business in Canada to 5%, (which is comparable with the rate reduction that would apply to dividend payments by a Canadian corporation to its U.S. parent). It also provides for an exemption from branch tax in respect of the first CDN$500,000 of branch profits, net of prior years' losses, which must be shared among related or non-arm's length corporations. This "lifetime" exemption can result in tax savings of up to CDN$25,000 (i.e. $500,000 x 5%) and the repatriation of such exempt branch profits will not be subject to Canadian withholding taxes.

Capital Gains

Article XIII of the Treaty limits Canada's jurisdiction to tax gains from the disposition of property by a U.S. resident. Paragraphs 1 and 2 of this Article provide that Canada may impose income tax on gains of a U.S. resident from the disposition of real property situated in Canada, and personal property forming part of the business property of a permanent establishment in Canada. For the purpose of this Article, real property situated in Canada includes a share of the capital stock of a company that is resident in Canada, if the value of the shares is derived principally from real property situated in Canada, and an interest in a partnership, trust or estate, the value of which is derived principally from real property situated in Canada. Real property is defined in Article VI of the Treaty to include rights to explore for or to exploit mineral deposits, sources and other natural resources such as oil and gas as well as rights to amounts computed by reference to the amount or value of production from such resources. Interestingly, under the Treaty, shares of non-Canadian resident corporations cannot be "real property situated in Canada," even if such corporation's value is derived from Canadian real estate. Paragraph 4 of Article XIII provides that gains of a U.S. resident from the disposition of any property that is not specifically subject to Canadian tax under the Treaty is taxable only in the U.S. Accordingly, a U.S. resident's gain from the disposition of shares of a corporation resident in Canada will generally be exempt from Canadian income tax if the value of the shares is not derived principally from real property situated in Canada at the time of the disposition of the shares, even if the shares are taxable Canadian property, as discussed above under the heading "Federal Income Taxes."

Similar provisions, as the ones discussed above, are found in most of Canada's tax treaties. However, several treaties including those entered into with Japan and Australia, do not exclude Canadian tax on capital gains in respect of taxable Canadian property by non-residents.

Treaty Entitlement

The Treaty provides relief from Canadian income taxes only to residents of the U.S., as defined in Article IV of the Treaty. A "resident of a Contracting State" means "any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature."

In *The Queen v. Crown Forest Industries Limited*,[41] the Supreme Court of Canada established that the concept of residence for the purpose of the Treaty entails "being subject to as comprehensive a tax liability as is imposed by a state," and that such comprehensive taxation is taxation on worldwide income. Accordingly, the CRA has applied these indicia in determining whether certain special types of non-resident entities are residents of the U.S., and thus eligible for Treaty benefits.

"S" Corporation

A corporation that files an election under Subchapter S of the *Internal Revenue Code*[42] is commonly referred to as an "S" Corporation. This type of corporation may be treated as a flow-through entity for U.S. federal income tax purposes. However, administratively, the CRA considers an "S" Corporation to be a resident of the U.S. for the purposes of the Treaty.

U.S. Limited Liability Company

A U.S. limited liability company ("LLC") that is treated as a flow-through entity for U.S. income tax purposes will not generally be subject to U.S. income tax on its worldwide income. The CRA took the position that an LLC was not liable to tax and was thus not a resident of the U.S. for purposes of the Treaty, and would not qualify for the benefits offered by the Treaty. Without the relief granted by the Treaty, dividends payable by a Canadian corporation to the U.S. LLC would be subject to withholding tax at a rate of 25%. The relief for capital gains, the rules governing the allocation of business profits, and the reduction in the Canadian branch tax under the Treaty, would also not be available. It should be noted that the CRA's position may be incorrect (see *TD Securities (USA) LLC*, a decision of the Tax Court of Canada in April 2010).[43]

41 95 D.T.C. 5389 at 5395.
42 Title 26 of the United States Code (26 U.S.C.).
43 2010 D.T.C. 1137. This case held that an LLC was liable to tax in the U.S. and therefore a resident in the U.S. under the Treaty. Although the CRA did not appeal this decision it has publically stated that it disagrees with the decision.

However, the Treaty was amended effective January 1, 2009 and it now enables Canada to "look-through" U.S. entities that are fiscally transparent to determine their entitlement to Treaty benefits. Although an LLC itself is not entitled to Treaty benefits, under the Treaty after January 1, 2009, an LLC can claim the benefits that are available to its U.S. resident members as a result of the look-through provisions.

Limitation on Benefits Provision

The Treaty has been recently amended to include a limitation of benefits ("LOB") provision which deals with entities that are not ultimately owned by U.S. entities or by public corporations, the principal class of shares of which are primarily and regularly traded on recognized U.S. or Canadian stock exchanges. The LOB rules are aimed at countering "treaty shopping" by non-residents. This is the first LOB provision utilized by Canada and, accordingly, there is only limited guidance in Canada on such rules. In general terms, the rules operate to deny Treaty benefits to any U.S. entity which otherwise meets the requirements under the Treaty, unless certain tests are met.

Generally, a U.S. or Canadian public company whose shares regularly trade on a recognized Canadian or U.S. stock exchange can benefit from the Treaty. A U.S. company controlled by five or less U.S. individuals who own at least 50% of the votes and value of the company can also benefit from the Treaty. In addition, U.S. residents may qualify for Treaty benefits under the LOB provision if the income in question is earned in Canada in connection with, or incidental to, a trade or business carried on in the U.S., and the trade or business in the U.S. is substantial in relation to the activity carried on in Canada. In certain situations, the U.S. resident may qualify for certain Treaty benefits if the ultimate owner of the U.S. resident is a resident of a country with which Canada has entered into a comprehensive tax convention, which provides similar treaty benefits as those set out in the Treaty, and certain other tests are satisfied. Alternatively, a U.S. resident may apply to the Canadian Competent Authority for a determination of the applicability of Treaty benefits on the basis of all relevant factors. In this regard, it will be necessary to show that the principle purpose of the creation and existence of the U.S. resident was not to obtain benefits under the Treaty that would otherwise not be available, and that it would be appropriate, having regard to the purposes of the LOB rules, to not deny Treaty benefits. If the CRA determines that either test applies, the U.S. resident will be granted the benefits of the Treaty.

It should be noted that at present, the Treaty is the only one which includes a LOB provision which is applicable to Canadian taxes.

Structuring Considerations

This section outlines some of the Canadian income tax implications of carrying on business in Canada through a branch or a subsidiary, including the use of an unlimited liability company ("ULC").

Canadian Subsidiary

A subsidiary incorporated in Canada is generally considered to be a Canadian resident for income tax purposes. It is subject to Canadian income tax on its income earned anywhere in the world from any source and a credit for foreign taxes paid on non-Canadian income.

The income of the Canadian subsidiary that is subject to Canadian income tax is generally calculated in accordance with generally accepted accounting principles. However, there are numerous inclusions and deductions which are specifically required or not permitted under the Act.

The Canadian tax rules treat capital gains more favourably than ordinary business or trading income. Generally, only one-half of realized capital gains, net of capital losses, are included in income.

In general terms, the Act permits a corporation to carry back for three years and carry forward for twenty years, non-capital losses (also referred to as net operating losses or "NOLs"). Such losses can generally be applied by the corporation against any form of income. Capital losses can be carried back three years and carried forward indefinitely but can only be used to offset capital gains. The direct or indirect acquisition of control of a corporation may limit the carry back and carry forward of both types of losses as well as certain other tax attributes of a corporation.

An efficient means of reducing the Canadian tax liability of the Canadian subsidiary involves having the U.S. parent corporation charge reasonable expenses to the subsidiary that are deductible in computing income of the subsidiary for Canadian income tax purposes. For instance, the U.S. parent corporation might charge the Canadian subsidiary a reasonable management or administration fee.

The parent corporation may also lend funds to the Canadian subsidiary and charge a reasonable rate of interest. Subject to the thin capitalization rules discussed below, the Canadian subsidiary will be able to deduct the interest paid to its parent. However, withholding tax may apply on the interest payment made by the Canadian subsidiary to its parent. As noted above, for U.S. parent corporations which can benefit from the Treaty, recent amendments to the Treaty have eliminated the withholding tax on interest paid to U.S. related parties which is not "participating interest," as defined in the Treaty.

Branch

A foreign company that is not resident in Canada is subject to Canadian income tax on income earned from any business carried on in Canada. If a business is carried on in Canada through a branch operation, the income attributable to that branch will be subject to income tax in much the same way, as if it had been earned by a subsidiary. However, the majority of Canada's tax treaties generally provide that the business profits of a foreign enterprise derived from carrying on business in Canada will only be taxable in Canada if they are attributable to a permanent establishment situated in Canada (see the discussion on "Business Profits" above).

A non-Canadian corporation carrying on its business as a branch will be subject to income tax as discussed above, on the income attributable to its Canadian branch. The determination of such net-taxable income will involve determining the gross profit on a reasonable allocation basis from its activities in Canada (this normally involves complex accounting allocations, keeping separate books and records, or segregating the Canadian operations in the corporation's books). In theory, a certain portion of the gross profit could be allocated to the head office to reflect its contribution to the branch in the form of management and administration services.

A foreign corporation carrying on business in Canada will also be subject to Canadian branch tax as discussed above. For U.S. corporations which benefit from the Treaty, the rate is 5%. However, the first CDN$500,000 of the corporation's earnings will be exempt from such taxes under the Treaty, and as such, the repatriation of such exempt profits to the head office will not be subject to withholding taxes.

The exemption can result in tax savings of up to CDN$25,000 (i.e. $500,000 x 5%). Therefore, in certain situations, for U.S. companies, it may be efficient to carry on the Canadian operations initially through a branch and then to transfer the Canadian business to a Canadian corporation after the earnings of the branch exceed the CDN$500,000 exemption threshold.

Using an Unlimited Liability Company ("ULC")

The "check-the-box" rules under the U.S. *Treasury Regulations*[44] permit a Canadian corporate entity to elect to be treated as a flow-through entity for U.S. income tax purposes, if the corporate entity does not provide limited liability protection to its shareholders. Nova Scotia, Alberta and British Columbia are the only Canadian provinces that offer the flexibility of creating a ULC under their provincial statutes.

It is important to understand that a ULC is treated as a corporation for Canadian income tax purposes and is subject to the same Canadian income tax consequences as any Canadian corporation. Accordingly, it is liable to pay Canadian income taxes on its worldwide income.

However, amendments to the Treaty which came into effect January 1, 2010, contain a rule that denies certain benefits of the Treaty to U.S. residents that have an interest in a ULC, where the ULC is a disregarded entity for U.S. tax purposes. An amount of income, profit or gain paid by a ULC (including interest or dividends) to a U.S. resident, no longer qualifies for a reduced rate of withholding tax under the Treaty. Rather, the statutory withholding rate of 25% under the Act applies to such amounts. However, the CRA has issued several technical interpretations and advance income tax rulings which permit a ULC to benefit from the withholding tax rate set out in the Treaty on interest and dividends, so long as such interest and dividend payments are structured in the manner set out in such interpretations and rulings. Therefore, existing structures using a ULC should be reviewed.

Choosing Between a Subsidiary and a Branch Operation

If business is carried on in Canada through a branch operation having a permanent establishment, it is subject to income tax in much the same way as if it had been earned by a subsidiary. However, it is important to note that in the case of a U.S. resident who benefits from the Treaty, that person may generally carry on business in Canada without attracting Canadian income tax, provided that no permanent establishment, as defined in the Treaty, is maintained in Canada. In addition, when a non-resident decides to carry on business in Canada (whether or not subject to tax), appropriate federal, as well as provincial or territorial income tax returns, will need to be filed.

On a long-term basis, the use of a subsidiary is often found to be preferable since the existence of a separate legal entity in Canada encourages and facilitates the separate accounting necessary for Canadian purposes and the determination of acceptable cross-border transfer pricing. On the other hand, the ability of the non-resident to use Canadian source start-up losses may encourage the use of a branch operation until the Canadian business becomes profitable. Subsequently, branch assets can generally be transferred to a Canadian subsidiary on a tax-free basis for Canadian purposes, provided that the appropriate tax elections are made. Before a foreign corporation transfers assets to a Canadian subsidiary, caution should be taken since it could trigger taxes in the foreign corporation's country of residence, and in certain situations, Canadian tax.

44 (26 C.F.R).

Whether a business comes to Canada as a branch or subsidiary can impact the valuation of imported goods. For customs purposes, it is generally the transaction value (the value at which goods are sold to the Canadian importer) that forms the value for duty (i.e. the base upon which customs duties are calculated). However, where goods are transferred to a Canadian branch, a sale may not take place. Consequently, the transfer price may not form the value for duty and another value, such as the selling price in Canada less certain adjustments, may become the value for duty.

Whether a business operates in Canada as a branch or subsidiary can affect whether the provisions of section 105 of the *Income Tax Regulations* apply. This provision applies to fees paid to a non-resident for services provided in Canada (other than remuneration for employment services) and requires the payor to deduct and withhold 15% of such payment. If the services are rendered in Quebec, a further 9% must be withheld and remitted to Revenue Quebec. This withholding tax is on account of any Canadian or Quebec taxes owed by the non-resident. If the non-resident is not subject to Canadian or Quebec tax (e.g. because it does not have a permanent establishment in Canada and can benefit from the Treaty provisions applicable to business profits), it can apply for a refund of the withholding tax. A waiver of this withholding may be obtained from the CRA and Revenue Quebec in certain circumstances. In contrast, payments received by a Canadian subsidiary in respect of services provided in Canada will not be subject to this provision.

Financing Considerations

Thin Capitalization Rules

Under the "thin capitalization rules," a portion of any interest that a corporation resident in Canada pays to a specified non-resident shareholder (or a person with whom the shareholder does not deal at arm's length) on amounts owing by it to such persons, may not be deductible in computing the Canadian corporation's income. A "specified non-resident shareholder" is generally defined to include a non-resident person along with certain non-arm's length parties who own shares of the corporation having 25% or more of the votes or value of all of the issued shares of the corporation.

Generally, if the ratio of debt (owing to the specified shareholder or the shareholder's non-arm's length parties) to equity (paid-up capital, surplus and retained earnings) of the Canadian corporation does not exceed two-to-one, no amount of interest expense will be disallowed. If the debt-to-equity ratio exceeds two-to-one, the interest on the excess debt will not be deductible. The calculation of the debt-to-equity ratio uses monthly debt and equity values.

The thin capitalization rules are relevant for determining taxable income only for corporations resident in Canada and thus do not apply to non-resident corporations which operate in Canada through a branch. However, the determination of Canadian branch profits of a non-resident corporation requires a reasonable allocation of expenses between the Canadian branch and other sources of income. Consequently, even if the use of borrowed funds by a non-resident corporation can be traced entirely to a Canadian branch, the deductible amount of interest might be limited to a reasonable allocation of such interest to the Canadian branch. In addition, interest-bearing indebtedness used to finance a Canadian branch operation of a non-resident corporation will generally reduce the corporation's investment allowance for the purposes of calculating Canadian branch taxes (please see "Branch Taxes" above).

Where the Canadian operation is capitalized by debt financing, gross revenue will be subject to less Canadian tax, by virtue of the interest deduction, than if the parent corporation had financed the Canadian operation with equity. Although interest payments made to related non-resident parties generally are subject to a greater withholding tax rate than dividend payments, for U.S. corporations which benefit from the Treaty, withholding tax on most related party interest payments has been eliminated under the Treaty, as discussed above.

Where a foreign corporation (e.g. a parent corporation) guarantees the debt of the Canadian payor, the Canadian payor can avoid the thin capitalization rules by borrowing from a third party lender rather than its U.S. parent. Thus, determining whether it is preferable to finance with debt or equity requires a consideration of both Canadian and foreign income tax consequences, since the interest income received by the foreign corporation will usually be taxable in the foreign jurisdiction.

Where a non-resident guarantees the debt of the Canadian payor and the Canadian payor pays a guarantee fee, the amount of such fee is deemed to be interest for purposes of the Act. If such deemed interest is paid to an arm's length party, the deemed amount will not be subject to withholding tax under the Act. In addition, the Treaty provides that there will be no withholding tax on such payments if the recipient is a U.S. resident entitled to Treaty benefits. For all other non-arm's length party guarantee fees paid to non-U.S. non-residents, withholding taxes may apply. It should be noted that there may be transfer pricing issues related to the value of the guarantee payment, as well as foreign tax issues. (please see "Transfer Pricing Rules" above).

Paid-up Capital

"Paid-up capital" in respect of a class of shares of a corporation, is an income tax term that is defined under the Act. However, Canadian corporate statutes do not use the term "paid-up capital," per se, but refer to the equivalent corporate concept as "stated capital." Accordingly, the starting point for the computation of paid-up capital of a class of shares of capital stock of a corporation, for income tax purposes, is the stated capital of that class, as determined under the applicable corporate statute. The Act provides many adjustments to paid-up capital which can apply in many situations.

Canadian corporate laws require a corporation to maintain a stated capital account and, except in specific circumstances, to add the full amount of any consideration that the corporation receives for any shares which the corporation issues for the public Canadian corporation. Generally, for non-public Canadian corporations, paid-up capital can be returned to a non-resident parent by a Canadian subsidiary without any Canadian withholding tax.

Unlike many jurisdictions including the U.S., there is no Canadian income tax requirement that a corporation pay out its profits before returning capital and, therefore, the foreign parent of a Canadian non-public subsidiary should consider a return of capital as a method to extract after-tax profits from the subsidiary on a tax effective basis. In addition, if a foreign corporation initially uses equity to capitalize its Canadian non-public subsidiary, it will generally be able to reduce the equity and increase the amount of debt financing without giving rise to any adverse Canadian income tax consequences, assuming that such actions do not give rise to interest deduction limitations under the thin capitalization rules discussed above.

Tax-Deferred Sale of Shares and Amalgamations

Sections 85 and 85.1 of the Act provide for the tax-deferred transfer of property to a corporation. Section 87 of the Act relates to tax-deferred amalgamations.

Section 85 Election

Section 85 of the Act permits the transfer of property to a corporation on a tax-deferred basis by electing the amount at which the transfer takes place for tax purposes. The transferor (seller) may be any "taxpayer," including a non-resident person. However, the transferee (purchasing corporation) must be a "taxable Canadian corporation." The seller must receive at least one share of capital stock of the purchasing corporation. The seller may also receive non-share consideration, which may include cash, promissory notes, the assumption of debt or any other property. Certain types of property may not be "rolled over" into a corporation under section 85, including real property or an interest in real property owned by a non-resident that is not used in a business carried on in Canada by such non-resident. To affect the rollover under section 85, the seller and the purchasing corporation must jointly execute a prescribed election form and file it with the CRA in the prescribed time. The elected amount cannot be less than the tax cost to the taxpayer of the property and it cannot be more than the fair market value of the property. In addition, the elected amount cannot be less than the fair market value of any non-share consideration received by the transferor.

Section 85.1 – Share-for-Share Exchanges

Section 85.1 allows a taxpayer (seller) to transfer shares of a corporation on a tax-deferred basis to another corporation for treasury shares of the transferee (purchaser) corporation. The following conditions must be satisfied for section 85.1 to apply:

1. the purchaser of the "old shares" must be a Canadian corporation;
2. the "old shares" that are being disposed of by the seller must be shares of a taxable Canadian corporation and must be held as capital property;
3. the purchaser corporation must issue its own shares (i.e. treasury) to the seller in exchange for the "old shares" owned by the seller of any particular class of another corporation that is a taxable Canadian corporation; and
4. the only consideration the seller receives for the "old shares" is shares of one particular class of the purchaser corporation.

Once these conditions are met, the provision applies automatically and no election is required for the tax-deferred rollover to the seller. The tax cost of the transferred shares to the purchaser corporation is the lesser of the fair market value of the shares and the paid up capital of the shares, immediately before the exchange. However, the seller can opt out of the "automatic" rollover.

The rollover under section 85.1 does not apply in the following circumstances:

1. the seller and purchaser were, immediately before the exchange, not dealing with each other at arm's length;
2. immediately after the exchange, the seller or persons not at arm's length with the seller, alone or together, controlled the purchaser or beneficially owned more than 50% of the value of all outstanding shares of the purchaser;

3. a section 85 election was filed in respect of the transaction to which the particular taxpayer is a party; or
4. non-share consideration was received by the seller for the transferred shares.

It should be noted that a section 85 election may provide the purchaser with a higher tax cost if the vendor's tax cost of the transferred shares is greater than the paid-up capital of the transferred shares.

Tax Deferral for Target Shareholders

The availability of the tax-deferral benefits under sections 85 and 85.1 of the Act can often facilitate transactions since a buyer could purchase a target corporation without causing immediate tax consequences to the target shareholders. In an all-cash deal, the selling shareholders will realize a capital gain to the extent that the proceeds of disposition of their shares exceed their tax cost and reasonable costs of disposition. However, where the buyer has the ability to issue shares or cause shares to be issued to the target shareholders as consideration, the provisions of sections 85 and 85.1 could be used to provide such shareholders with the opportunity to defer all or a portion of their gain.

Although no similar rule permits a tax-deferred transfer of property to a non-resident corporation, it is possible for a non-resident corporation to offer a tax-deferral to the shareholders of the target corporation by offering exchangeable shares. Under a typical exchangeable share transaction, a Canadian acquisition company acquires the shares of the target corporation and issues to the sellers its shares that are exchangeable into shares of the non-resident parent corporation. The terms and conditions of the exchangeable shares may be designed to place the holders of such shares in the same economic position as if the holders owned the shares of the non-resident corporation (see the discussion on Exchangeable Shares under the section "Overview of Canadian Securities Legislation – Plan of Arrangement," in Chapter 1 of this guide).

Amalgamations

A tax deferral can also be offered to shareholders of a target company through an acquisition strategy that involves an amalgamation. Section 87 of the Act provides for the merger of two or more taxable Canadian corporations (the "predecessor corporations") into a new corporate entity (the "amalgamated corporation"). For tax purposes, the amalgamated corporation is treated as a continuation of the predecessor corporations, standing in their place with respect to various assets, liabilities, surpluses and other tax-oriented accounts.

This tax-deferred merger under section 87 is available under the following conditions:

a. the merger must involve two or more corporations, each of which was immediately before the merger, a "taxable Canadian corporation";
b. all of the property of the predecessor corporations immediately before the merger, except amounts receivable from any predecessor corporation or shares of the capital stock of any predecessor corporation, must become the property of the amalgamated corporation;
c. all of the liabilities of the predecessor corporations immediately before the merger, except amounts payable to any predecessor corporation, must become liabilities of the amalgamated corporation;
d. all of the shareholders of the predecessor corporations immediately before the merger, except any shareholder that is a predecessor corporation, must receive shares of the capital stock of the amalgamated corporation; and

e. none of the foregoing requirements has been accomplished as a result of the acquisition of property of one corporation by another corporation, pursuant to the purchase of that property by the other corporation or as a result of the distribution of that property to the other corporation on the winding-up of the corporation.

Section 87 applies automatically without the need for an election to be filed.

The shareholders of each predecessor corporation (other than shareholders who are other predecessor corporations) will be deemed to have disposed of their shares in the predecessor corporations (the "old shares") for proceeds equal to the adjusted cost base of such shares. The shareholders will then be deemed to have acquired shares of the amalgamated corporation at the price equal to the adjusted cost base of the old shares.

Triangular Amalgamations

The Act also permits the tax-deferred amalgamation of two or more taxable Canadian corporations where the Canadian parent corporation of the amalgamated entity issues shares to the shareholders of the predecessor corporations. This type of amalgamation is commonly referred to as a "triangular amalgamation."

A triangular amalgamation can also be conducted on a tax-deferred basis under the rules in section 87 of the Act, even though the shareholders of the predecessor corporation are not shareholders of the new corporation. In this case, the amalgamation will not give rise to a taxable event resulting in a corporate level of taxes. Similarly, the shareholders of the predecessor corporation will dispose of their shares on a tax-free basis when they become shareholders of the new corporation's parent.

Other Considerations

Assets vs. Shares

The decision to acquire the assets of the Canadian business or the shares of the operating company will affect the manner in which the acquisition is completed.

From a commercial perspective, a purchaser would generally prefer to acquire the assets of a business to limit its exposure to the "hidden" liabilities of the target company. It also provides the purchaser with the ability to choose the assets that the purchaser wants in order to carry on the Canadian business. The acquisition of assets could also be advantageous from an income tax perspective, by allowing the purchaser to allocate the purchase price in the most tax-efficient manner (i.e. to the extent permitted, the purchaser should allocate the purchase price to assets which will give rise to the greatest depreciation deductions) under the Act.

In addition, asset acquisitions also provide more flexibility with respect to the choice of carrying on business through a branch or a subsidiary. If a U.S. corporation acquires the assets of a Canadian target business, the U.S. corporation can continue to carry on that business as a Canadian branch. If it later decides to carry on the business through a Canadian subsidiary, it can generally transfer the assets of the business to a Canadian corporation on a tax-deferred basis under section 85 of the Act. In contrast, if a U.S. corporation acquires the shares of a Canadian company, it would be necessary to wind-up the Canadian target or transfer the assets to a U.S. corporation. Neither of these options can be carried out on a tax-deferred basis and could result in significant Canadian income tax consequences.

Commodity taxes, such as GST, QST, HST, PST or land transfer taxes, may be imposed on the sale of assets, whereas transfer taxes will not be imposed on the sale of shares (please see "Commodity Taxes and Payroll Taxes" above). In addition, a purchaser might be interested in acquiring the shares of the operating company where the company has significant non-capital loss carryovers that might be available to reduce taxes payable in respect of future profits of the Canadian operations, subject to the detailed rules in the Act.

Increasing Tax Cost Under ss. 88(1)(d) of the Act

Generally, if the shares of a corporation are acquired, there is a very limited ability to increase the tax cost of the assets of the corporation. However, in certain situations, if the acquisition is by a Canadian corporation, that Canadian corporation can increase the tax cost base of non-depreciable capital properties of the acquired corporation, such as land, shares and partnership interests, through an amalgamation or wind-up. This step-up in cost base is sometimes referred to as the "88(1)(d) bump." However, it should be noted that the Act imposes significant limitations on when the "bump" can be utilized.

Benefits of Acquiring Canadian Company Using Canadian Holding Company

Perhaps the simplest way of acquiring a Canadian corporation is to purchase the shares of the corporation directly. However, such direct acquisitions by a non-resident corporation may not be the most tax-efficient means of doing so from a Canadian income tax perspective. Consider the following example where the purchase price for all of the issued shares of a Canadian corporation is less than paid-up capital of the corporation.

Example 1: Foreignco acquires all of the issued shares of the Canadian target corporation, Targetco, for $100M. The paid-up capital of Targetco is only $50M. Targetco would only be able to return $50M on a tax-free basis to its parent, Foreignco, although Foreignco paid $100M for the issued shares of the company. Foreignco can improve its Canadian tax position by using a Canadian acquisition corporation.

Example 2: Foreignco subscribes for shares of a new Canco in the amount of $100M. Canco uses the funds to acquire all of the issued shares of the Canadian target corporation, Targetco, for $100M.

In this example, Canco would have paid-up capital of $100M, which could be returned to Foreignco on a tax-free basis. Foreignco's ability to refinance the equity financing with debt has increased from $33.3M to $66.6M. Note, however, that this strategy to increase paid-up capital must be executed at the time of the acquisition. Subsequently "rolling over" the shares of Targetco into Canco will not have the desired tax effect.

In addition, if Canco borrows money to finance the acquisition of Targetco, and Targetco and Canco are subsequently combined, the acquisition indebtedness can be converted into operating debt. Interest payments are currently deductible, provided that the amount of interest is reasonable, subject to the thin capitalization rules (discussed above under the section "Thin Capitalization Rules"), and to the potential withholding taxes that may be applicable.

The use of Canco as the acquisition vehicle may also permit an increase in the tax cost of non depreciable assets owned by Targetco (please see "Increasing Tax Cost" under ss. 88(1)(d) of the Act discussed above).

Canadian Capital Gains Exemption

It should be noted that Canadian resident individuals are entitled to a one-time CDN$750,000 capital gains exemption in respect of the sale of qualified small business corporation ("QSBC") shares. This exemption can result in a tax saving of approximately $175,000 for each individual entitled to the exemption. Therefore, if a buyer wishes to purchase shares of a Canadian corporation which qualify as QSBC shares from Canadian resident individuals, the sellers will most likely want to structure the transaction as a share sale, as opposed to an asset sale if they can benefit from the exemption.

Section 116 Notification

As discussed above in the section "Federal Income Taxes," Canada taxes non-residents on the disposition of taxable Canadian property. Accordingly, if a non-resident sells property which is not taxable Canadian property, there is no Canadian tax payable under the Act. As also discussed above, if the property sold is taxable Canadian property, an applicable tax treaty may exempt the transaction from Canadian tax. It should be noted that if the seller is a non-Canadian resident and the property is taxable Canadian property, in certain situations there is a requirement under section 116 of the Act to notify the CRA and obtain a clearance certificate, even if there is no tax payable under a tax treaty or the sale results in a capital loss. In addition, the purchaser from a non-Canadian resident seller may be required to withhold a portion of the purchase price until the clearance certificate is obtained. (The notification procedure is simplified and the withholding requirement may not apply if the property is "treaty protected property," as defined in the Act.) In addition to penalties, the Act imposes a joint liability on the purchaser for the non-resident seller's tax liability if a clearance certificate is not obtained when required under the Act.

Conclusion

Any non-resident buyer of a Canadian business must consider the Canadian and provincial income, commodity and payroll tax issues related to the acquisition, so that the taxes payable in connection with the acquisition and the operation of the Canadian business are minimized. In addition, the buyer must take into account taxes in other relevant jurisdictions. It is critical that tax advice be obtained in the early stages of any acquisition planning so that the transaction can be structured effectively.

Competition Act – Merger Notification and Review

Introduction

Canada's competition (or antitrust) law is found in the *Competition Act*[45] (the "Act"), a federal statute generally applicable to all industries throughout Canada. There are no provincial statutes of general application that provide for merger notification or review for the purpose of a competitive impact assessment.

Parties proposing mergers and acquisitions, or similar types of transactions, must consider two issues:

1. Is the transaction one that is subject to notification obligations before it can be completed?
2. Is the transaction one that will attract close review and a challenge by the Canadian Competition Bureau (the "Bureau")?

The Act contains merger notification provisions analogous to those in the U.S. *Hart-Scott-Rodino Antitrust Improvements Act of 1976*.[46] Substantive merger review and challenge provisions are similar to the standard found in section 7 of the *Clayton Act*.[47]

Overview

Administration and Enforcement

In Canada, the Commissioner of Competition (the "Commissioner") is the head of the Bureau and administers and enforces the Act. The Commissioner's responsibilities are analogous to those of the U.S. agencies: the Federal Trade Commission and the U.S. Department of Justice. In this chapter, references to the Bureau and the Commissioner are synonymous.

The Commissioner conducts investigations and initiates proceedings either in the courts or before the Competition Tribunal (the "Tribunal"), which is composed of lay and judicial members. Merger notification filings are made to the Commissioner, and proceedings to block or dissolve a merger are brought by the Commissioner to the Tribunal.

Parties to certain types of transactions that exceed prescribed financial thresholds are obliged to notify the Commissioner of the transaction before it is completed, pay a $50,000 filing fee and wait until the waiting period (30 days, but if the Commissioner delivers a supplemental information request within that time, then 30 days after the requested information is supplied) expires before they may complete the transaction. The purpose of the merger notification provisions is to provide the Commissioner with information about economically significant transactions. The Bureau can then determine whether a transaction should be challenged under the merger provisions of the Act on the basis that it would result in a substantial lessening or prevention of competition in any market.

45 (R.S., 1985, c. C-34).
46 15 U.S.C s.18.
47 15 U.S.C s.12 et seq.

Notification

Notification Thresholds

The two notification thresholds, both of which must be exceeded in order to trigger the notification obligation, are:

1. size of parties test:
   a. the parties to the transaction, together with their affiliates in aggregate, have assets in Canada or annual gross revenues from sales in, from, or into Canada over $400 million; and
2. size of transaction test:
   a. in the case of an acquisition of assets, the aggregate value of the assets in Canada, or the gross revenues from sales in or from Canada generated from those acquired assets, exceed $73 million[48];
   b. in the case of an acquisition of shares, the aggregate value of the assets of the corporation being acquired, or the gross revenue from sales in or from Canada generated from those assets, is above $73 million, and the person or persons acquiring the shares, together with their affiliates, would own more than 20% of the voting shares in the case of a public corporation, or 35% in the case of a private corporation. Where the acquiring party, together with its affiliates, already owns more than 20% of the voting shares of a public corporation, or more than 35% of a private corporation, then notification is required only where the proposed acquisition would result in the acquiring party, together with its affiliates, owning more than 50% of the corporation;
   c. in the case of an amalgamation, the value of the assets in Canada of at least two of the amalgamating corporations together with it's affiliates or the gross revenues from sales in or from Canada generated from those assets, is over $73 million;
   d. in the case of a combination of two or more persons to carry on a business otherwise than through a corporation (e.g. formation of a partnership or joint venture), the aggregate value of the assets in Canada that are the subject matter of the combination, or the gross revenues from sales in or from Canada generated from those assets, is over $73 million;
   e. in the case of an acquisition of an interest in an existing combination that carries on an operating business otherwise than through a corporation (e.g. an acquisition of interests in a partnership or joint venture), the aggregate value of the assets in Canada that are the subject matter of the combination, or the gross revenues from sales in or from Canada generated from those assets, would be over $73 million, and where, as a result of the acquisition of the interest, the person or persons acquiring the interest, together with their affiliates, would hold an aggregate interest in the combination of over 35%, or, if they already have more than a 35% interest, would have more than a 50% interest.

Generally, the asset values or gross revenues from sales are determined by reference to the most recently completed year-end audited financial statement book values. However, these may be subject to adjustment if there are material post year-end changes. There are regulations that specify how asset values or revenues are to be calculated. In close cases, a more detailed analysis should be conducted to determine whether the transaction exceeds the thresholds and is subject to notification. The rules for determining whether a

48 The size of the transaction threshold is indexed and changes annually.

transaction is notifiable are technical and, in some instances, determining whether a transaction is notifiable can be complex.

Notification Procedure, Waiting and Review Periods

If both the size of parties and the size of transaction thresholds are exceeded, the parties to the proposed transaction are required, before completing it, to file a notification together with the required information. The required information to be supplied is set out in the *Notifiable Transactions Regulations.*[49]

Filing of the prescribed information triggers a 30-day waiting period before the transaction can close. If the Commissioner delivers a supplemental information request within the 30 days requiring specified further information, then the waiting period is extended until 30 days after the supplemental request is satisfied.

The information gathering process can be onerous, especially if a supplemental request is delivered. The basic prescribed information requirements include: detailed information about the parties, their product lines, their suppliers and customers, future business plans, and copies of all reports or analyses prepared or received by senior officers for the purpose of analyzing the transaction. The information that may be required by a supplemental information request is not prescribed and will be determined by the Bureau on a case-specific basis. The Bureau will take into account the potential competition issues engaged by the transaction, as reflected in the prescribed information supplied, and the Bureau's preliminary internal analysis. In either event, the waiting period begins on the day on which the required information is received by the Commissioner.

The Commissioner's review of a transaction that raises significant concerns about anti-competitive effects may take longer than the statutory waiting period. Although parties to the transaction are not prohibited from closing after the expiry of that waiting period, absent an interim injunction from the Tribunal on the application of the Commissioner, they face the risk that the Commissioner will then bring proceedings before the Tribunal for a merger remedies order that may retroactively impact the closed deal.

Even if a transaction does not exceed the notification thresholds, it may still be reviewed and challenged in proceedings before the Tribunal under the substantive merger provisions of the Act within one-year period following substantial completion.

Typically, in appropriate cases, parties who file notifications with the Bureau also ask for a form of clearance (either an advance ruling certificate or a "no-action letter," which are discussed below).

Clearances and Timing

In addition to, or in lieu of, a prescribed notification, parties may apply for an advance ruling certificate which, if issued by the Commissioner, precludes a challenge to the transaction, provided that the information submitted by the parties, upon which the issuance of the certificate was based, is substantially accurate. Where only a request for an advance ruling certificate is made, the parties will typically, in the alternative, request from the Commissioner a "no-action" letter and a statutory waiver of the obligation to notify and supply the prescribed filing information.

49 SOR/87-348.

If the Commissioner is not entirely comfortable with the competitive effects of a transaction, rather than an advance ruling certificate, a no-action letter will be issued indicating that the Commissioner does not, at that time, have grounds to challenge the transaction under the merger provisions. A no-action letter provides the parties with sufficient comfort and will typically satisfy the competition-related closing condition in the merger agreement, although such transactions can technically be challenged for a year after closing.

The Commissioner may, in cases where the Bureau has not completed its assessment and does not have sufficient concerns to apply for an interim injunction, issue a "close at your own risk" letter. At the time of negotiating purchase and sale agreements, parties should consider what type of condition under the Act best suits their needs and risk tolerances.

The Bureau has also published service standards for the review of transactions and the preparation of advance ruling certificates. The maximum turnaround times are 14 days for a non-complex transaction and 45 days for a complex transaction unless a supplementary information request has been issued, in which case the period is 30 days from the time that the supplementary information has been provided to the Bureau. Generally, the categorization of the degree of complexity depends on the nature of the industry, the extent to which the transaction raises issues of competitive effects, and the number of geographic and product markets that must be examined. It is to be expected that transactions which have generated a supplemental information request or "second request" from the Bureau will fall under the complex service standard. The Bureau's service standards are generally, but not invariably, met.

Exemptions from Pre-Notification

A transaction is not notifiable if it falls within specified exemptions. Transactions between corporations which are all affiliates are exempt. A transaction with respect to which an advance ruling certificate has been issued is also exempt. In addition, the following are exempted from notification obligations:

1. acquisitions of real property, or goods in the ordinary course of business which do not amount to substantially all of the assets of a business, or an operating segment of a business;[50]
2. acquisitions of voting shares or an interest in a combination solely for the purposes of underwriting;
3. acquisitions of voting shares, or an interest in a combination, or assets that result from a gift or inheritance;
4. acquisitions of collateral or receivables, or an acquisition resulting from a foreclosure or default, or forming part of a debt workout made by a creditor;
5. acquisitions of certain Canadian resource properties where the buyer intends to carry out exploration or development activities;
6. asset securitization transactions; and
7. joint ventures that meet certain criteria.

Substantive Merger Review under the Act

A merger can be challenged by the Commissioner in proceedings before the Tribunal on the grounds that the merger, or proposed merger, prevents or lessens, or is likely to prevent or lessen, competition substantially in any market. Section 91 of the Act contains a definition of "merger" which is very broad and includes:

50 Referred to as the "paper clip" exemption, this deals with the acquisition of supplies, equipment and realty for use in the ordinary course of business.

> the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or a part of a business of a competitor, supplier, customer or other person.

Most mergers which are reviewed under the Act fall within the typical types of merger and acquisition (M&A) transactions, but the definition is broad enough to capture various types of strategic alliances, joint ventures and other cooperative agreements.

The Tribunal may prohibit a proposed merger, or order full or partial divestiture or dissolution of a completed merger. The Act lists factors that the Tribunal may consider in determining competitive impact, which include:

1. the extent of foreign competition;
2. whether the business of one of the parties has failed or is likely to fail;
3. the extent to which acceptable substitutes to the products of the merging parties are or are likely to become available;
4. any barriers to entry into a market (including tariff and non-tariff barriers to international trade, interprovincial barriers to trade and regulatory controls over entry) and the effect of the merger on such barriers; and
5. the extent to which there will be effective competition remaining after the merger and the likelihood that the merger may result in the removal of a vigorous and effective competitor.

The Act also prohibits the Tribunal from finding that a merger prevents or lessens, or is likely to prevent or lessen, competition substantially based solely on evidence of concentration or market share.

A unique feature of the Act is that it provides for an efficiencies defence which prohibits the Tribunal from issuing a remedial order, if the merging parties can demonstrate that there would be efficiency gains from the merger that would be greater than, and would offset the effects of, any prevention or lessening of competition likely to result from the merger. The efficiency defence has been the subject of extensive litigation and is discussed in more detail below.

Merger Assessment by the Commissioner

Few mergers are contested in proceedings before the Tribunal. Challenge proceedings are similar to complex commercial litigation with oral and documentary discovery, expense, delay and uncertainty, making most transactions commercially unattractive. As such, a decision by the Commissioner to challenge a transaction in proceedings before the Tribunal is usually enough to cause the parties to either abandon it, or enter into negotiations with the Commissioner to make modifications to address anti-competitive effects, which may then become the subject of a consent agreement to be entered as an order of the Tribunal.

Merger Enforcement Guidelines

The Commissioner's approach to assessing a merger and determining whether to issue a form of clearance (either an advance ruling certificate or a no-action letter) or to challenge it, is set out in the general Merger

Enforcement Guidelines ("MEGs").[51] The Bureau has also issued specific merger enforcement guidelines applicable to certain industries, such as banks, and has consulted on similar guidelines issued by Transport Canada in respect of mergers in the federal transportation sector, which require separate statutory approval under the *Canada Transportation Act*[52] and notification under both that statute and the Act. As this example illustrates, it is important to remember that mergers in certain sectors invoke specific guidelines and statutory regimes apart from the Act, and require additional approvals of other federal authorities.

The general MEGs are not binding on the Tribunal or the Commissioner, but they provide assistance in understanding the approach the Commissioner takes when examining and assessing proposed mergers. They are similar to the guidelines issued by the U.S. Department of Justice and the Federal Trade Commission.

Substantial Lessening of Competition

The fundamental principle in the MEGs is that a merger will likely prevent or lessen competition substantially when the parties to the merger are more likely to be in a position to exercise a materially greater degree of market power in a substantial part of the market for two years or more, than if the merger did not proceed. Market power can be exercised unilaterally or interdependently.

Market Definition

The first stage of a merger analysis is to define the relevant market for the purpose of a competitive impact assessment. The MEGs use a hypothetical monopolist test similar to the U.S. Merger Guidelines. A relevant market is defined as the smallest group of products, including at least one product of the merging parties, and the smallest geographic area in which a sole profit-maximizing seller (a "hypothetical monopolist") would impose and sustain a significant and non-transitory price increase, above levels that would likely exist in the absence of the merger. Generally, the MEGs consider a 5% increase to be significant and a one-year period to be non-transitory.

The consideration of potential competition from new entrants or expansion by smaller firms within the market is considered at a later stage.

Although the hypothetical monopolist approach for defining a relevant market is highly conceptual, in most cases, a preliminary examination is based on more practical considerations. These include functional substitutability, who the merging parties or their customers consider to be competitors, and information contained in prospectuses, financial reports, securities filings, offering memoranda and other similar sources. If data is available and market definition is complex, expert economists may be consulted to assist the parties in defining the market, calculating market shares and concentration, and applying the hypothetical monopolist model.

Safe Harbours

Once a market is defined both in terms of geographical boundaries and product or service, the Bureau, as a starting point, will measure the impact that the merger will likely have on market share and concentration. Generally, where the post-merger market share of the merged entity would be less than 35%, the Commissioner will not likely challenge the merger on the basis of concern related to unilateral exercise of market power.

51 The Bureau is in the course of updating the MEGs and in June 2011 issued for consultation a draft revision.
52 (S.C. 1996, c.10

A merger will not likely be challenged on the basis of concerns relating to the coordinated exercise of market power where, after the merger, the market share accounted for by the four largest firms would be less than 65% or the post-merger market share of the merged firm would be less than 10%. These thresholds are often referred to as "safe harbours" that distinguish between mergers that will not be reviewed closely and will likely receive a clearance, from those that will receive a more detailed analysis of competitive effects.

Where a proposed merger is outside the safe harbours, the Bureau will look at other criteria, the most important being barriers to entry. The consideration of barriers to entry includes tariff and non-tariff barriers to international trade, regulation, intellectual property issues and the extent to which entry involves incurring significant sunk costs.

While transactions that fall below the notifiable thresholds are reviewable under the substantive merger provisions, their relatively low economic significance will be a factor in determining whether the Commissioner will choose to spend the Bureau's limited resources to challenge the transaction. In addition, relatively low asset values may imply low barriers to entry.

Vertical Mergers

A merger of firms that have a customer/supplier relationship is called a "vertical merger" and may raise concerns when it increases barriers to entry, facilitates coordinated behaviour, or forecloses competitors from access to inputs or distribution channels. While issues arising from vertical mergers are far less common than with horizontal mergers, the parties should be prepared to consider whether there are any vertical issues and address them in their notification submissions to the Bureau.

Efficiencies

Canadian competition law differs from U.S. antitrust law in that the Act expressly provides for an efficiency defense. This prohibits the Tribunal from issuing a remedial order if the parties can establish that the efficiency gains from the merger would be greater than, and would offset the prevention or lessening of, competition that would result from it.

The issues of the types of efficiencies that can be counted and the appropriate welfare standard that should be used to measure anti-competitive effects were recently the subject of lengthy litigation in *Commissioner of Competition v. Superior Propane*.[53] Initially, the Tribunal applied a total surplus standard and found that the efficiency defense prevailed, because the gains in efficiency that would result from the merger of the two largest propane distribution companies in Canada would exceed the dead weight loss (total welfare loss) that would result from the combination of the price increase and the decrease in output that would likely follow the merger. The Tribunal decided that income transfers from consumers to producers should be treated as neutral for the purposes of the consideration of the efficiencies defense.

On appeal, the Federal Court of Appeal decided that the Tribunal had not applied the correct test and that it should have given consideration to the impact of the transfer of wealth from consumers to producers. It sent the case back to the Tribunal for re-determination. The Tribunal reassessed the impact in accordance with the directions from the Court of Appeal, but still concluded that the efficiencies outweighed the effects of the lessening of competition.

53 [2003] 3 F.C. 529 (F.C.A.).

The MEGs set out the Bureau's approach to considering an efficiencies justification to an otherwise anti-competitive merger. The Bureau has also published a Bulletin on efficiencies in merger reviews.

While mergers that are cleared on the basis of the efficiencies defense alone will not be that common, in preparing a submission to the Commissioner to obtain an advance ruling certificate or a no-action letter, efficiencies are relevant and should be addressed if they are an important business motivation for the transaction.

Conclusion

Parties proposing M&A transactions involving Canadian businesses must address the following:

1. Is the transaction notifiable under the Act?
2. Will the transaction attract a close review from the Bureau and risk a challenge under the substantive merger provisions?
3. Does the transaction involve a business sector which may entail additional merger issues and review, as well as the input of regulators other than the Bureau?

Generally, in the case of a horizontal merger (where businesses of merging parties overlap, in a competitive sense, in products and territory), some analysis must be done to assess the risks and to develop a strategy for notification, requesting clearances, sorting timing issues and addressing the potential concerns of the Bureau. While the Commissioner is the only party that can bring proceedings under the substantive merger provisions, there are provisions for third parties to ask for intervenor status. Often what motivates the Bureau to closely review and challenge a transaction are concerns by customers, suppliers or other levels of government. Concerns of customers are the most influential. Concerns by competitors are also considered, but are scrutinized to ensure that the basis of the complaint is relevant to a true competitive impact assessment and not motivated by ulterior strategic objectives.

Filings of notifications under the Act, as well as information and submissions provided to the Bureau, are confidential. However, in the merger review process, the Bureau typically contacts market participants, and the parties' customers and suppliers, to solicit their views on competitive impacts of the merger. The Bureau is sensitive about disclosing non-public information without the merging parties' consent. Careful consideration of this issue is required up front in situations of sensitive mergers.

While the focus of the Bureau's assessment is the impact on competition in Canada, in cases of multi-jurisdictional transactions, one can expect that the competition authorities in the jurisdictions affected will cooperate with each other. Parties and their lawyers should ensure that concerns in each affected jurisdiction are addressed and that submissions made to the agencies in all jurisdictions are consistent.

Merger law in Canada can give rise to difficult issues relating to competitive impact and the necessity of pre-notification. The Competition Group at Fraser Milner Casgrain LLP is experienced in complex domestic and international mergers, and can provide practical advice and assistance to facilitate expeditious completion of merger transactions.

Foreign Investment Notification and Approval Under the *Investment Canada Act*

Introduction

The *Investment Canada Act*[54] (the "Act") regulates certain investments in Canadian businesses by non-Canadians.[55] The purpose of the Act is "to provide for the review of significant investments in Canada by non-Canadians in order to ensure net benefit to Canada and to provide a mechanism for reviewing and blocking investments that may be injurious to national security."

The Act is administered and enforced by Industry Canada and, in particular, the Director of Investments (the "Director") at the Investment Canada Review Division, with ultimate approval for reviewable transactions granted by the Minister of Industry (the "Minister"). For certain investments that relate to Canadian cultural businesses, the Department of Canadian Heritage ("Heritage Canada") is responsible for administering the Act.

Although first enacted in 1985, and despite a large number of reviews of foreign investments to date, only two foreign investments outside of the cultural sector have been refused.

While compliance with the legislation can range from a minor inconvenience to the more involved negotiation of specific undertakings relating to future employment, capital expenditures or other commitments, it has not proved to be a significant impediment to foreign investors wishing to invest in Canada.

Notification and Review

Under the Act, investments by non-Canadians to establish a new Canadian business, or to acquire control of an existing Canadian business, are subject to either notification only or to review and approval, unless a specific exemption applies.[56] Notification is an administrative formality and is required in respect of the establishment of a new Canadian business by non-Canadians or the acquisition of control by non-Canadians of an existing Canadian business that falls below the applicable threshold for review. A notification must be filed at any time prior to, or within 30 days of, the implementation of the investment.

Where an investment is reviewable, the investor is obliged to complete an application providing prescribed information about the investor and its plans for the existing Canadian business. In the case of most reviewable investments, including all direct acquisitions of control of a Canadian business, the investment cannot be implemented unless it has been reviewed and the Minister is satisfied that the investment is likely to be of net benefit to Canada. There are no filing fees in respect of either a notification or an application for review.

54 (R.S., 1985, c. 28 (1st Supp.))
55 For the purposes of the Act, a non-Canadian includes any entity that is not controlled or beneficially owned by Canadians.
56 Exemptions are set out in section 10 of the Act.

Thresholds for Review

In respect of the acquisition of control of an existing Canadian business by non-Canadians, there are several thresholds for review under the Act. The applicable threshold depends on:

1. whether the non-Canadian investor is from a country that is a member of the World Trade Organization (a "WTO investor"[57]) or the Canadian business being acquired is already controlled by a WTO investor;
2. whether the acquisition of control is direct or indirect; and
3. whether the Canadian business that is being acquired is a "cultural" business, as defined in the Act.

At the time of publication, direct acquisitions of control of a Canadian business[58] (that is not a "cultural" business) will be subject to review where the book value of the assets of the Canadian business equals or exceeds CDN$312 million. However, recent amendments to the Act, not yet proclaimed, will see this changed. Under the amended threshold, direct acquisitions of control of a Canadian business (that is not a "cultural" business) will be subject to review where the "enterprise value" of the Canadian business exceeds CDN$600 million[59] for WTO investors, and where the "book value" of the assets of the Canadian business equals or exceeds CDN$5 million for non-WTO investors.[60] "Enterprise value" has not been defined yet.

Indirect acquisitions of control (that is, the acquisition of a corporation incorporated outside of Canada which in turn controls, directly or indirectly, a Canadian entity) are generally not reviewable. Indirect acquisitions can be subject to review, if the acquisitions are by non-WTO investors from sellers who are non-WTO investors or Canadians and the assets of the Canadian business being acquired have a book value of CDN$50 million or more, or if the book value of the assets is below the CDN$50 million threshold, the book value of the assets is at least CDN$5 million and comprises greater than one-half of the value of the entities whose control is being acquired pursuant to the transaction.

Cultural Businesses

Notwithstanding the foregoing, if the Canadian business being acquired is a cultural business, then the threshold for review of direct acquisitions of control is CDN$5 million and for indirect acquisitions of control is CDN$50 million, respectively, regardless of whether the investor qualifies as a WTO investor. These cultural business thresholds are based on the book value of the assets, as already described, and will not be based on "enterprise value" even when the amendments to the Act are implemented."

Note that acquisitions of control of cultural businesses that fall below these thresholds, as well as establishments of cultural businesses, may still be subject to review if they include activities described in (a) to (d) below, upon the order of the Governor in Council (i.e., the federal cabinet).

57 In determining whether an investor is a WTO investor, if the ultimate parent is a widely held public company that is not controlled in fact through the ownership of its voting interests, the acquiring entity would be considered to be a WTO investor if two-thirds of the members of the board of directors of the public company are any combination of Canadians and nationals of other WTO member states.

58 A direct acquisition includes an asset acquisition or the acquisition of the shares of a Canadian-based company or the ownership interests in a Canadian partnership trust or joint venture.

59 This will be the WTO investor threshold for the two years following implementation of the amendment, increasing to CDN$800 million for the two years after that, and then to CDN$1 billion for the next year and part-year to December 31, with annual indexing for inflation thereafter pursuant to a formula in section 14.1 of the Act.

60 Under the Act, the book value of the assets is the aggregate of all assets being acquired, as shown in the audited financial statements (or unaudited statements if audited statements are not available), for the Canadian business for its fiscal year immediately preceding the implementation of the investment.

The Act and related regulations set out the following definition for the "cultural business" activities that trigger review at the lower thresholds:

> "cultural business" means a Canadian business that carries on any of the following activities, namely, (a) the publication, distribution or sale of books, magazines, periodicals or newspapers in print or machine readable form, other than the sole activity of printing or typesetting; (b) the production, distribution, sale or exhibition of film or video recordings; (c) the production, distribution, sale or exhibition of audio or video music recordings; (d) the publication, distribution or sale of music in print or machine readable form; or (e) radio communication in which the transmissions are intended for direct reception by the general public, any radio, television and cable television broadcasting undertakings, and any satellite programming and broadcast network services.

As outlined above, if the Canadian business being acquired is engaged in any of these business activities, then the lower thresholds for review apply to both direct and indirect acquisitions of control. Heritage Canada, and not Industry Canada, is responsible for review and approval of the investment where the Canadian business is considered to be a "cultural business."

Applications for Review and the Review Process

Where the applicable threshold for review has been exceeded, the investor must file an application for review providing prescribed information about the investor and the Canadian business. In case of direct acquisitions, the application must be filed prior to the completion of the transaction and must include a description of the purchaser's plans for the Canadian business. The plans should set out the net benefit of the investment to Canada including, if applicable, capital expenditure projections and the effect of the investment on employment, the location of head office, technological development, competition and participation of Canadians in the senior management of the Canadian business.

The Act provides that, following receipt of a completed application for review, the Minister has an initial 45-day period to make a determination as to whether the investment is likely to be of net benefit to Canada. This period may be extended by the Minister unilaterally for a further 30 days. Any additional extensions must be with the consent of the investor. In cases where the Minister has advised the investor, within the initial 45-day period or any extension period, that he or she is not satisfied that the investment is likely to be of net benefit to Canada, the investor may make representations and submit undertakings in respect of the Canadian business within 30 days of the notice, or any further period agreed upon between the investor and the Minister. After the expiry of the 30 days, or any agreed upon extension, the Minister must notify the investor that he or she is, or is not, satisfied that the investment will be of net benefit to Canada. If the investment was implemented but is not ultimately approved by the Minister, the investor must divest control of the Canadian business.

A reviewable investment may not be implemented prior to the investor receiving a decision from the Minister that the investment is of net benefit to Canada, unless one of three exceptions applies:

1. where the Minister is satisfied that a delay in implementing the investment would result in undue hardship to the investor or would jeopardize the operations of the Canadian business, and the Minister has sent a notice to the investor permitting implementation of the investment prior to completion of the review process;
2. where the investment is an indirect acquisition (as defined above); and
3. where the investment is not normally reviewable, but the Government exercises its authority by Order-in-Council to review the investment because it involves a cultural business activity.

Net Benefit to Canada Test

Where an investment is reviewable, the investor may not implement the investment or complete the transaction until the Minister has determined that the investment is or is likely to be of "net benefit to Canada," in the language of the Act. In determining this, the Minister will consider the following statutory factors:

1. the effect on the level of economic activity in Canada, employment, resource processing, the utilization of parts and services produced in Canada, and exports from Canada;
2. the degree and significance of participation by Canadians in the Canadian business or new Canadian business, and in any industry or industries in Canada;
3. the effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;
4. the effect of the investment on competition within any industry in Canada;
5. the compatibility of the investment with national industrial, economic and cultural policies; and
6. the contribution of the investment to Canada's ability to compete in world markets.

Net Benefit - State-owned enterprises

In December 2007, guidelines were released by Industry Canada outlining the criteria for review of investments by state-owned enterprises ("SOEs"). The guidelines, which apply to enterprises that are owned or controlled directly or indirectly by a foreign government, state that the Minister will review the corporate governance and commercial orientation of SOEs in determining whether reviewable acquisitions of control by SOEs are of net benefit to Canada. Governance will be evaluated to determine adherence to Canadian corporate governance standards, such as commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders. The Minister will also assess whether the business to be acquired by the SOE will continue to have the ability to operate on a commercial basis regarding matters such as export markets, capital expenditures, and research and development.

National Security Review

In March 2009, the Act was amended to incorporate a new mechanism for the review of investments by non-Canadians which may be injurious to national security. This review may be applied to any investment in a Canadian business by a non-Canadian, including investments not otherwise subject to the legislation such as minority investments.

Pursuant to the national security screening process, the Governor in Council may take any measures in respect of the investment that the Governor in Council considers advisable to protect national security, including: (a) directing the purchaser not to implement the investment; (b) authorizing the investment on condition that the non-Canadian (i) give any written undertakings to Her Majesty in right of Canada relating to the investment that the Governor in Council considers necessary in the circumstances, or (ii) implement the investment on the terms and conditions contained in the order; or (c) requiring the purchaser to divest itself of control of the Canadian business or of its investment in the entity. In order to trigger a national security review, within 45 days of the date on which the notification or application for review has been filed and certified as complete or within 45 days of the date of closing of a transaction for which neither an application for review nor a notification is required, either (a) the Governor in Council must order a review of the transaction or (b) the Minister must issue a notice to the purchaser indicating that a review may be necessary on grounds of national security, in which case the Governor in Council has 25 days from the date of notice to order a review.

Undertakings and Progress Reports

In many cases, Industry Canada (or Heritage Canada in the case of cultural businesses) will require undertakings from the investor for a period of at least three years (often five years in the case of very large, high profile investments) following implementation of the investment that will demonstrate the "net benefit" of the investment to Canada. Undertakings are generally negotiated by the investor and Industry Canada and will relate to the statutory factors outlined above. The most common areas requiring undertaking commitments from investors include Canadian participation in management, location of the headquarters for the Canadian business, employment levels, ongoing capital expenditures, and increased technological development or productivity resulting from the investor's acquisition of control.

Once the investment has been determined to be of net benefit to Canada, the investor may proceed with its implementation. If undertakings are provided in connection with the plans for the Canadian business, the investor will be required to provide a progress report on the status of its plans and undertakings within 18 months of implementation. For cultural businesses, progress reports are usually requested by Heritage Canada on an annual basis.

Opinions

Where there is uncertainty or special circumstances exist, an investor may seek an opinion from the Minister or the Director with respect to any matter of interpretation of the Act. Once an opinion is issued by Industry Canada (or Heritage Canada in the case of cultural businesses), it is binding upon the Minister and the Director for so long as the material facts upon which the opinion was based remain substantially unchanged. The opinions sought generally concern the status of an individual or entity as a Canadian (and accordingly, whether the Act applies), and the application of the Act's provisions, including whether there are grounds for an early implementation of the investment. All information and submissions provided pursuant to the Act, or received by Industry Canada and its officials in relation to an investor or a Canadian business, are treated as privileged and confidential and may not be disclosed subject to limited exceptions, including for the purpose of administering the Act or with the consent of the parties to whom the information pertains.

Recent Developments

In May 2008, the Minister, for the first time, rejected a transaction that did not raise cultural or heritage concerns. The transaction involved the proposed CDN$1.3 billion acquisition of the information systems and geospatial service operations of MacDonald, Dettwiler and Associates Ltd. ("MDA") by US-based Alliant Techsystems Inc.

Since no decision was published (note that the Act was amended in 2007 to require the minister to provide reasons for a rejection), it is not certain on what basis the Minister concluded that the transaction was not likely to be of net benefit to Canada. It is likely that national security considerations were an important factor, given MDA's role as a pioneer of what are perceived to be leading-edge Canadian space technologies, including operation of Radarsat-2, a sophisticated surveillance satellite linked to Canada's ability to monitor possible violations of Canada's claims of Arctic sovereignty. Moreover, considerable public concern was expressed that the proposed sale would transfer to non-Canadians significant technologies developed at the expense of the public.

In November, 2010, a proposed $39 billion hostile take-over of Potash Corporation of Saskatchewan by the Anglo-Australian firm BHP Billiton was also rejected, following an intensive public relations campaign led by the Premier of Saskatchewan which placed significant political pressure on the minority Conservative federal government. Reasons for the decision were not provided, since BHP Billiton technically withdrew its application for review.

Undertakings are subject to "force majeure" type of exceptions but otherwise enforceable. In July 2009, the Minster brought legal proceedings against US Steel to compel it to comply with undertakings (given when it acquired Stelco in 2007) relating to employment and production at Stelco's Canadian facility. The Minister is also seeking a penalty of $10,000/day for each day of non-compliance.

Conclusion

Foreign investment in Canada can require approval under the Act. The review process can give rise to difficult issues and may necessitate the negotiation of undertakings that affect how business is conducted for a period of time following acquisition. Fraser Milner Casgrain LLP has extensive expertise in assisting clients to navigate the requirements of the Act.

Labour Relations and Employment Considerations

Introduction

When acquiring the shares or assets of a Canadian private or public company, a number of employment issues need to be addressed. Since the issues in share acquisitions are very different from asset purchases, these two types of transactions are addressed separately.

Before discussing these issues, it is helpful to have an understanding of a few basic concepts of Canadian employment law. Set out below is background information on employment agreements and termination of employment.

Background Information

Employment Agreements

Employees may be employed under a written employment agreement, an oral employment agreement or a collective agreement.

In the unionized workplace, all employees in the bargaining unit are employed under the collective agreement, which is signed by the employer and the union. The Supreme Court of Canada has held that there is no room for individual negotiation or employment agreements in the unionized setting and that the collective agreement is the only employment agreement, with the union being the sole bargaining representative of the employees in the bargaining unit.

In the non-union workforce, employees are employed under a written or unwritten employment agreement. In Canada, written employment agreements are still relatively rare, especially in the lower ranks, although increasing in popularity. Any employees without a written employment agreement have, at common law, an oral employment agreement. It is for this reason that this section refers, from time to time, to the employment agreements of employees, even where there is no written document. Where there is no written term regarding termination of employment, it is an implied term of employment that employment will only be terminated for cause or upon reasonable notice.

Termination of Employment

Canadian severance laws are quite generous and there is no employment at will. It is important for the buyer of a corporation to understand the potential costs of a future reduction in the workforce, the scope of possible outstanding severance claims for dismissals that occurred before the acquisition date, and whether and how those obligations can be limited.

Regardless of where the target business is located, there are two levels of severance obligations to be assessed: statutory and common law (civil law in the province of Quebec).

Statutory Requirements

Each province and territory in Canada has local legislation which sets out the minimum notice period to be provided in the event of a termination of employment other than for just cause (which has a fairly narrow statutory definition). These amounts are fairly modest and are based on an employee's length of service. They generally range from one week to eight weeks of notice of termination, which can be provided as pay in lieu of notice if the termination is to be immediate. It is not possible to contract out of or waive these statutory requirements, even with the consent of the employee.

The statutory notice requirements increase significantly where group dismissals occur. Most provinces define a mass dismissal as the termination of 50 or more employees within a specified time frame. However, in some provinces, it is as low as 10 dismissals. The notice required in these situations can be as great as 18 weeks. There are often additional requirements, such as notifying the provincial Ministry of Labour of the impending terminations, posting notices in the workplace or assisting employees in securing new employment.

The Province of Ontario and the federal jurisdiction require payment of statutory severance pay in addition to notice of termination. The federal *Canada Labour Code*[61] (the "Code") applies only to federally regulated employers including airlines, banks, broadcasters, and those involved in telecommunications or interprovincial shipping, trucking and railroads. Most businesses are regulated by the laws of the province in which they operate. Fortunately, provincial employment legislation is fairly consistent across the country.

Unlike termination notice (which can be provided as time worked or as pay in lieu of notice of termination), statutory severance pay is always a cash payment. Ontario's severance pay requirements apply only to employees with at least five years of service and only to employers with an annual Ontario payroll of at least CDN$2.5 million. The severance formula is one week of pay per year of service, to a maximum of 26 weeks. Severance pay under the Code is the greater of five days' pay or two days of pay per year of service, and is only payable to those who have completed 12 months of continuous service with the employer.

A very small number of jurisdictions (namely Quebec, Nova Scotia and the federally regulated sector) have legislation requiring just cause for the dismissal of employees with a certain amount of seniority. The federal rule does not apply where the termination is a result of lack of work or the discontinuance of a function. In these jurisdictions, government tribunals have the power to award damages or reinstate employees dismissed without cause.

Common Law and Civil Law Requirements

Of far more significance than the modest statutory termination requirements are the Canadian common law and the Quebec civil law requirements.

Where an employee is dismissed for cause, there is no advance notice of termination or severance pay required whatsoever. Not surprisingly, "cause" has been narrowly defined by our courts as certain acts including fraud, dishonesty, gross incompetence, serious sexual harassment, conflict of interest, theft and sometimes serious insubordination. All other terminations of employment, including a redundancy

61 (R.S., 1985, c.L-2).

or downsizing, are terminations without cause and the amount of notice of termination required under the contract of employment must be given.

If there is no express termination provision in the employment contract, the courts imply an obligation to provide reasonable notice. Reasonable notice is determined on the basis of a number of factors such as the individual employee's length of service, position, age and compensation. A civil claim for severance where there was no cause for the dismissal, is known in Canada as a wrongful dismissal claim (although there is no connotation of any wrongful activity. It is "wrongful" only to the extent that insufficient notice was given). "Reasonable notice" at common law is very generous and, when making an estimate of severance costs, one month per year of service provides a rough guideline, although it is not entirely reliable. Reasonable notice generally does not exceed 24 months in total.

Where an employee has signed an employment agreement which contains notice or severance terms, the contractual terms are generally binding. Courts will refuse to uphold severance provisions which provide less than the provincial legislation or where the employee received no consideration for signing the employment agreement (for example, employment had already commenced before the contract was signed). In some cases, the courts may also refuse to enforce an employment agreement where: the contract was unconscionable; the employee was coerced into signing it; the employee did not understand the contract; or, where the contact was signed so many years earlier that, with subsequent changes in function, position or size of the company, the contract is no longer relevant.

Acquisition of Shares

A change in ownership of share equity does not change the identity of the employer. The acquired corporation, despite the change in ownership, continues to be the employer under any employment agreements and any collective agreement with a trade union.

Because there is no termination of employment, there is no break in service or seniority of the employees. The purchaser inherits all of the past service and the associated termination obligations.

In the case of a unionized workplace, the collective agreement remains in place and continues to govern all terms and conditions of employment and to bind the corporation.

Due Diligence

As the new owner acquires all of the liabilities of the corporation in a share acquisition comprehensive due diligence is critical. The potential buyer should assess the cost of any outstanding employee-related liabilities. For example, there may be outstanding wrongful dismissal lawsuits, complaints under human rights legislation, workers' compensation penalties, occupational health and safety charges, complaints under employment standards legislation or grievances in a unionized workplace. It is also prudent to obtain a history of recent reductions in workforce and individual terminations.

Canadian employees are fairly litigious in dismissal situations. It would be wise for a new owner to determine if there are any outstanding severance claims where a release has not yet been obtained and where the dismissal occurred within the last two years. Limitation periods for wrongful dismissal claims vary from two to six years.

During due diligence, a potential buyer should review all employment agreements, severance agreements and change in control agreements. This is especially important where the buyer plans to downsize the workforce in the future. The current cost of administering the payroll, benefits, pension plan and workers' compensation premiums should be reviewed. But, equally important, the buyer should look for agreements that increase any of these costs in the near future.

Workers' compensation coverage in Canada is not administered through private insurance. Rather, employers pay premiums to a provincial fund based on the size of the payroll and type of industry. A provincial government body makes all claims decisions.

The usual payroll taxes include income tax, Canada Pension Plan (or Quebec Pension Plan) contributions (there is an employee and an employer contribution toward this government-run pension scheme) and Employment Insurance premiums (there is an employee and an employer component to the government-run insurance plan which provides benefits during periods of unemployment, maternity/parental leave, disability and compassionate care leave). Some provinces have payroll taxes to pay for healthcare, while others have premiums paid to the provincial government medicare plan. Workers' compensation premiums are paid to the applicable provincial workers' compensation board.

Any collective agreements should be reviewed carefully. Depending on the future plans of the purchaser, the following issues should be addressed: Are there any restrictions on contracting out, subcontracting or plant closures? Are there any severance terms? (Severance clauses are not overly common in collective agreements as all unionized employees are protected by the provincial employment standards legislation.) What is the scope of the union's bargaining rights? (For example, do they cover all employees, including office employees, production employees, part-time employees and students? Do the bargaining rights extend to one particular street address, to the entire municipality or even the entire province? Could they apply to other operations already owned by the buyer?)

As well, a collective agreement can reveal future costs in terms of scheduled pay and benefit increases. The manner in which the pension and benefits are structured can restrict the buyer's flexibility in changing plans. If, for example, the carrier and type of coverage is specifically set out in the collective agreement, it would be a breach of the contract to change carriers or plans.

The term of the collective agreement will reveal when the contract expires and when labour unrest or a strike could next occur.

Depending on the type of business conducted by the target company, a review of any non-competition, non-solicitation, non-disclosure and intellectual property rights agreements can be helpful.

Representations and Warranties

In addition to conducting thorough due diligence, the buyer of shares should require certain representations and warranties from the seller. Typical representations and warranties include the following statements: that all payroll taxes and premiums are current; vacation pay has been accrued; there is compliance with applicable employment, labour and health and safety laws; there are no outstanding grievances, arbitrations, complaints or employee claims; there are no outstanding occupational health and safety charges or orders; and that there is compliance with pay equity laws (there is pay equity legislation in the private sector in the provinces of Ontario and Quebec, and in the federal sector). There should also be a representation and warranty as to whether there is any known union or employee association organizing activity, contemplated work stoppages or pending applications for certification by a union.

It is also possible to obtain certificates from certain government agencies as to whether workers' compensation premiums have been paid in full, or if there are any outstanding statutory complaints or charges. However, the procedure can be time consuming and typically the seller must authorize the disclosure in writing. Accordingly, the purchaser should be prepared to clarify these matters through due diligence and/or require appropriate representations and warranties.

Asset Purchase

In an asset purchase, there is a change in employer and, technically, all employees are terminated at the moment of sale. However, if the employees are rehired by the purchaser, severance costs are avoided because each Canadian jurisdiction has "sale of business" legislation which provides that where a business or part of a business is transferred, disposed of or sold to a purchaser, and the purchaser employs the employees, the employees' service is deemed unbroken for purposes of the legislation. Similarly, at common law, if an employee accepts equivalent employment with the purchaser, he or she has mitigated any wrongful dismissal damages. If the employee declines an offer of comparable employment from the purchaser, he or she has failed to mitigate and in any claim for damages at common law damages will be limited or not awarded. In some provinces, such as Ontario, employees have the right to refuse an offer of employment from the purchaser and still receive their statutory termination and severance pay.

Occasionally, purchasers from outside Canada seek to hire the employees of the target business as new hires with no past service. This is ineffective for statutory severance purposes, as employment standards legislation protects past service and employees cannot contract out of these statutory rights. At common law, while it is possible to avoid past service, this would be unusual and may not be acceptable to the seller. As well, this would have to be explicitly stated in each employee's offer letter or contract and carefully drafted to ensure that it does not run contrary to the employment standards legislation.

Due to the cost of severance (and often out of concern for the employees), the seller will typically try to require the purchaser to hire all of the employees. As well, the seller will normally want a clause requiring the purchaser to make offers of employment on terms and conditions that are substantially similar in the aggregate to those enjoyed by the employees before the sale. Obviously, if the offers are inferior, the chances increase that the employees will not accept the purchaser's offers. Unless the asset purchase agreement allocates liabilities otherwise, the severance costs will be to the account of the seller. An asset purchase can allow a purchaser more flexibility as to how many employees it wishes to assume and on what terms, subject to what it can negotiate with the seller.

A purchaser should be aware that a unilateral adverse change to significant terms and conditions of employment (especially with respect to pay, bonus plan, calculation of commissions or benefits) made after the purchase can constitute a constructive dismissal. Where an employee does not accept an adverse change, he or she is entitled to quit and sue for damages for constructive dismissal. If changes to employment arrangements are contemplated and the purchase is by way of assets, the time to set them out is in the offer letter to the employee.

The comments above with respect to due diligence and seller's representations and warranties, apply equally to asset transactions. The asset purchase agreement normally should provide that all employee costs and claims that arose before the closing date are to the account of the seller, and all costs arising after the closing date are the responsibility of the purchaser.

The Unionized Workplace

Labour relations legislation across Canada contains similar sale of business or successorship provisions, which apply to the purchase of a unionized business whether by assets or shares. The legislation stipulates that the purchaser is bound to the collective agreement as if it were the original signatory to the contract. In other words, the purchaser must recognize the union as the exclusive bargaining agent for the employees and is bound to the collective agreement. Accordingly, the typical asset purchase agreement will require the purchaser to continue the employment of all unionized employees on identical terms and conditions of employment. There is normally no need to make any offers of employment; employment simply flows through from the seller to the purchaser. To change any of the terms and conditions of employment would constitute a breach of the collective agreement and could be taken to arbitration by the union. If the purchaser does not wish to hire all of the unionized employees, the layoff, bumping and seniority provisions of the collective agreement must be followed to effect a reduction in the workforce.

Generally, the provincial Labour Relations Boards distinguish between the purchase of discrete assets and the purchase of a viable business. Therefore, in some cases where only certain equipment is purchased and there is no value allocated to goodwill or, if the new business will be of a very different character than that carried on by the seller, the union successorship provisions may not apply.

The potential purchaser should be aware that if the seller is engaged in collective bargaining negotiations with the union while the sale is being actively contemplated, the seller has a statutory duty to disclose this significant development to the union at the bargaining table. Failure to disclose may constitute an unfair labour practice. In cases where bargaining is ongoing, the purchaser may wish to become involved in negotiations to some extent to ensure that the seller does not agree to an overly generous package with the union. Similarly, the purchaser may wish to become involved in order to ensure that the business is not headed towards a strike.

Employees on Leave of Absence

There are certain categories of absent employees that should be considered. A failure of a purchaser to offer employment to employees on sick leave or short-term disability could be construed as discrimination on the basis of disability. However, regardless of these concerns, purchasers typically will not wish to hire employees who are absent on long-term disability leave and agreements are often reached to leave these individuals on the benefit plans of the seller.

Employees absent on maternity or parental leave have a statutory right to reinstatement (which varies somewhat from province to province) and the seller will typically require the purchaser to hire all of these employees upon the expiry of their leaves of absence. Combined pregnancy and parental leave can be up to one year in length across the country (and up to 70 weeks in Quebec).

Similarly, in some provinces, employees who are absent due to a workplace injury and in receipt of workers' compensation benefits are protected under workers compensation legislation from termination of employment.

Amalgamations

An amalgamation does not create a new company. The usual analogy is that of two rivers flowing together to form one. Accordingly, there is no termination of employment of the employees. Nor are the liabilities and responsibilities of the two companies terminated.

When planning an amalgamation, due diligence should be conducted. The amalgamation may affect collective bargaining agreements (particularly if both companies have union agreements or business operations that are geographically close), stock option plans and employee benefits in particular.

It will also be necessary to comply with the registration requirements of the workers' compensation board in the province in which the amalgamation occurs, and to notify or register with other government departments. The benefit plan carrier(s) should be notified as well.

Data Privacy

The scope of access during due diligence has been affected by the federal *Personal Information Protection and Electronic Documents Act 6062*[62] ("PIPEDA"). PIPEDA stipulates that personal information in the control of the corporation (including information pertaining to customers, contractors and business partners) cannot be used or disclosed without the consent of the individual to whom the personal information applies. "Personal information" must be about an identifiable individual.

It is also possible that personal information pertaining to employees cannot be disclosed in certain cases. For example, if one is purchasing a federally-regulated business or employees are located in a province with its own privacy legislation, the employer cannot disclose personal information concerning employees without their consent although, fortunately, the provinces of Alberta and British Columbia have passed specific provisions to allow for disclosures during the sale process. Even in other provinces such as Ontario, which does not have its own private sector privacy legislation, employees' personal information cannot be disclosed under PIPEDA during a commercial activity, without their consent. The sale of a business may well meet the definition of a commercial activity. As a prudent measure, where a data room is set up for multiple potential bidders, identifiers linked to personal information should be deleted.

Any potential purchasers should be required to sign a comprehensive non-disclosure agreement, which provides that the potential purchaser will destroy or return all personal information disclosed during due diligence if the transaction is not concluded, and will protect the personal information in a manner comparable to that in which it is protected by the seller. Whenever possible, personal information should not have identifiers on it.

British Columbia and Alberta both have similar provincial privacy legislation that sets out a reasonable protocol which allows for disclosure of personal information in the context of an acquisition. It must be

62 2000, c.5.

borne in mind that the Province of Quebec has had personal information protection legislation in place since 1994. Local legal advice should be obtained if a transaction involves disclosure, use or transfer of personal information in Quebec.

Most provinces also have legislation relating to personal health information. If such information is involved, special consideration must be given to protecting its privacy.

Conclusion

Employment and labour issues can be of key significance in the acquisition of a business. Specialized legal advice should be obtained in each case to assess the risk in opportunities that are being explored and to minimize liabilities to the greatest extent permissible by law in the circumstances.

Pension and Benefits Considerations

Introduction

Given that pension liabilities have the potential to have a material effect on the structure of a deal, pension and benefits issues should be addressed as early as possible in any corporate transaction. This section provides a general overview of the significant issues which arise when a business with a registered pension plan is to be acquired, sold or merged with another business. It also briefly touches on other types of employee benefit arrangements which often trigger significant cost issues in corporate transactions.

Registered Pension Plans - General Statutory Framework

Canadian registered pension plans are subject to an assortment of federal and provincial pension legislation. Unlike the case with ERISA, there is no uniform pension legislation across the country.

Federal pension legislation applies to a plan whose members are employed in a sector that is within the legislative authority of the federal government (e.g. banking, shipping, broadcasting). If the federal pension legislation does not apply, then the pension legislation of the province in which the plan members are employed applies. A pension plan with members employed in various jurisdictions is subject to the pension laws of all the applicable jurisdictions.

Every pension plan must be registered with the pension regulator of the jurisdiction in which the majority of plan members are employed. The pension regulator enforces the pension laws of other jurisdictions that apply to the plan. In limited circumstances, dual registration may be required.

The lack of uniform pension legislation across Canada can be problematic for employers because pension legislation across the country is not always consistent.

All Canadian pension plans must be registered with the Canada Revenue Agency (the "CRA") and comply with specific provisions of the Canadian *Income Tax Act*[63] (the "Act") in order to receive favourable tax treatment. Eligible employer contributions to a registered pension plan can be set-off against business profits. Such contributions (and the earnings thereon) are not included in employees' income until pension benefits are paid out to the employees.

Types of Pension Plans

Generally, there are two types of pension plans:

1. a defined benefit plan ("DB plan"); and
2. a defined contribution plan (also known as a money purchase plan) ("DC plan").

A DB or DC plan can be either "contributory" (i.e. member contributions are required) or "non-contributory" (i.e. member contributions are either prohibited or voluntary). Some employers have "hybrid" DB/DC plans.

In a DB plan, the pension payable to a member is determined according to a pre-determined formula. There are many types of formulae that could be used, including final average earnings, career average earnings and flat benefit. For example, in a final average earnings plan, the employee might be entitled to

63 (1985, c.1 (5th Supp.))

an annual pension equal to one per cent of the average of his or her earnings in the last five years of his or her employment, multiplied by his or her total years of pensionable service, subject to the Act's maximum annual pension benefit limit. The employer's required contributions to the DB plan will vary depending on the actuarial methods and assumptions used to determine the required funding level, in order to provide the promised benefit and the actual investment returns on contributions made. Employers are basically obligated to ensure that the pension plan has sufficient assets to meet its promises. Given the nature of DB plans, the pension plan may contain a surplus or deficit.

In a DC plan, the contribution amount is fixed and is subject to contribution limits under the Act. For example, the employer contribution amount might be five per cent of the member's earnings, subject to the contribution limit in the Act. Upon death, termination of employment or retirement, the plan member (or spouse/beneficiary of the member, as applicable) is entitled to the accumulated contributions plus investment earnings thereon in the member's DC plan account.

Typically, the employees are provided with an array of investment funds, selected by the employer, from which they select their investment choices for their DC plan account. If the member is alive upon termination of employment or attainment of the relevant retirement age, the accumulated funds can be used to purchase an annuity for the member or transferred to other locked-in retirement vehicles. The value of an individual's retirement income under a DC plan is solely dependent upon the level of investment income that is accumulated on the fixed contributions. This is in contrast to a DB plan which provides a promised level of retirement income. As a result, a DC plan is considered to be riskier for an employee than a DB plan.

In Canada, only the federal jurisdiction has "safe harbour" provisions for the selection of the investment line-up for member assets in DC plans. No other Canadian pension legislation has any "safe harbour" provisions. In 2003, an association of Canadian regulators called the Joint Forum of Financial Market Regulators (which has representatives from Canadian pension, securities and insurance regulators) issued "Guidelines for Capital Accumulation Plans." These guidelines suggest best practices by employers and service providers, so that capital accumulation plan ("CAP") members will have the information and assistance they require to make appropriate investment decisions. A DC plan is considered to be a CAP.

Both DB and DC plans require, under law, an administrator to undertake the administration of the pension plan. Administrators have a statutory fiduciary duty to the members of the pension plan. Given the potential liability related to this duty, although some pension plans are overseen by a board of trustees, employers are typically forced to adopt this role for lack of an alternative administrator. Therefore this duty will often conflict with the duties of the directors and officers of the employer to the owners or shareholders of the employer. In order to mitigate liability for this conflict, often termed the two hats conflict, employers who act as administrators should consider establishing a comprehensive and transparent governance structure.

DC plans should not be confused with group registered retirement savings plans ("RRSP"). A group RRSP is a collection of individual RRSPs. An RRSP is a tax-deferred vehicle issued under the Act, which allows individuals to deduct from taxable income, the amounts contributed to their plan, up to certain contribution limits. Employers who wish to supplement employee contributions will gross-up employees' wages with the understanding that the grossed-up amounts are contributed to the employee's RRSP. The earnings on those amounts are not subject to tax while they are held within the RRSP. In general, all amounts received from an RRSP are included in the individual's income.

RRSPs are governed under the Act but are not subject to pension legislation. The CAP guidelines, referred to above, apply to RRSPs as well. Although a group RRSP may be structured like a DC plan (e.g. fixed contributions based on a percentage of earnings), they are two entirely different retirement arrangements. For example, funds held within a group RRSP are not required to be "locked-in" (i.e. they can only be used to provide periodic payments upon retirement). Thus, unlike DC plan funds which must be locked-in under pension laws, group RRSP funds can be commuted and withdrawn in cash by employees prior to retirement. From the point of view of a corporate transaction, if the target company has a group RRSP rather than a registered pension plan, the issues to be addressed are much less daunting.

Impact of Pension Legislation on Corporate Transactions

Generally, under pension legislation, if a member of the seller's registered pension plan, whose employment has been terminated (or "transferred" in the case of Quebec) due to the sale of a business, commences employment with the purchaser and participates in the purchaser's registered pension plan, the following applies:

A. the individual continues to be entitled to all benefits accrued in the seller's plan up to the date of the sale; and
B. for purposes of any eligibility conditions, vesting and locking-in of benefits in either plan, all years of employment and membership in the seller's plan and the purchaser's plan shall be taken into account (i.e. there is a deemed continuation of employment and plan membership for limited purposes, despite the fact that under common law there is a termination of employment with the seller). This deemed continuation of employment and plan membership is relevant in cases where, for example, a member of the seller's plan could be eligible for enhanced early retirement benefits if he or she meets the age and service combination of 85. The member's years of service with the purchaser would count towards that age and service threshold and the member could in fact become entitled to such enhanced early retirement benefits in the seller's plan by virtue of his or her employment with the purchaser.

(A) does not apply if the member's accrued assets and liabilities are transferred to the purchaser's plan.
(B) applies whether or not assets and liabilities are transferred.

Due to the deemed continuous employment and plan membership requirement in the sale of a business context, in general, affected members of the seller's plan are not entitled to exercise transfer options in respect of accrued benefits, which would otherwise be allowed if an employee terminated employment or plan membership in ordinary circumstances. One exception is British Columbia, which does allow members to exercise transfer options, despite the deemed continuous employment and plan membership rule.

In several provinces (including British Columbia, Ontario and Nova Scotia), if a successor registered pension plan is not provided by the purchaser to the transferred employees, the pension regulator may order the seller to wind-up its pension plan, either partially or fully, depending on whether some or all of the seller's plan members have been hired by the purchaser. The amount of notice that the regulator must provide regarding this type of order varies by province. Recent amendments will remove partial wind-ups for Ontario registered pension plans in the near future.

Even if a successor pension plan is provided, but is subsequently terminated by the purchaser in full or in part after closing, the seller is still vulnerable to a regulator's order to wind-up its plan (again, either in full or in part, depending on how many of the transferred employees have had their membership in the purchaser's plan terminated). The seller could seek a covenant from the purchaser that it will keep the successor pension plan in place for a specified period of time after closing (e.g. two years). As a purchaser, it is not desirable to be bound by such a covenant as several circumstances (e.g. insolvency or corporate re-structuring) could impair the purchaser's ability to comply with it.

In Alberta, a wind-up of the seller's plan is required if the assets and liabilities of the transferred employees are not assumed by the purchaser's pension plan, while in Saskatchewan, a wind-up might be ordered by the regulator in these same circumstances.

In a partial or full plan wind-up, the law requires that affected employees be granted immediate vesting and transfer options in respect of their accrued benefits. In addition, in Ontario and Nova Scotia, if the plan includes enhanced benefits (e.g. early retirement benefits) and certain age and service requirements are met, special "grow-in benefits" must be paid to members affected by a partial or full wind-up. Immediate vesting and "grow-in benefits" translate into higher-funding costs for the plan sponsor. (The grow-in benefits are only applicable to DB plans and are not relevant to DC plans.) Thus, in Ontario and Nova Scotia, the cost implications to a plan sponsor of a DB plan wind-up could be much more significant than those of a DC plan, depending on the enhanced benefits, if any, provided under the DB plan. Once partial wind-ups are removed from the Ontario pension regulations, Ontario members will be entitled to these additional benefits on their termination of employment or deemed employment if they participate in a successor pension plan.

A plan wind-up may also be undesirable to a seller because it triggers the legal requirement to distribute the surplus allocable to the terminated employees. In Alberta and British Columbia, the legislation clearly states that on a partial wind-up, an affected member is not automatically entitled to share in surplus. In Quebec, partial wind-ups do not exist. Federally regulated DB plans are generally not subject to this surplus distribution requirement upon a partial wind-up.

For both DB and DC plans, a wind-up report will have to be filed with the regulator for approval before any accrued benefits can be distributed from the plan. A wind-up report for a DC plan will be much simpler and less costly to prepare than a DB plan wind-up report, which will require actuarial input.

For all of the foregoing reasons, a seller may wish to avoid a requirement to wind-up its registered pension plan due to the sale of its business. Provisions can be negotiated in the sale agreement to reduce the risk of an immediate wind-up by requiring a purchaser to offer a successor plan.

Impact of Labour and Employment Law on Pension and Benefits Issues

Collective Agreement

Under labour relations legislation in Canada, successor employers (i.e. purchasers) are bound to the collective agreement which applies to the acquired business. The wording of the applicable collective agreement regarding the retirement benefits must be closely examined as it may specify the type of retirement plan that is required (e.g. group RRSP, DC plan or DB plan), the level of pension benefits that must be provided (if a DB plan), or the contribution rates required of the employer (if a DC plan) and/or other specific plan benefits (e.g. indexing, bridge benefits, early retirement benefits). The purchaser will be bound by these requirements when providing a new or existing plan for the transferred employees. To change any terms and conditions of employment would constitute a breach of the collective agreement.

If the collective agreement states that the employees are entitled to participate in a specifically named pension plan (e.g. "The Pension Plan for the Employees of Company ABC"), the purchaser must assume sponsorship and administration of that particular plan from the seller. However, this may not be feasible if the seller is retaining some of the employees and is transferring only a portion of its employees to the purchaser. In that case, the purchaser will have to establish a new plan or amend its existing plan so that it is identical to "The Pension Plan for the Employees of Company ABC" (i.e. in terms of type of plan, benefit levels, enhanced benefits, options etc.). Since the purchaser cannot technically comply with the collective agreement in this situation, negotiations with the union will also be necessary. The purchaser will also have to determine whether it wishes to transfer any accrued assets and liabilities of the transferred employees from the seller's plan to its own plan.

Purchasers may also be liable under successor employer labour legislation for pension and retiree health and welfare benefits that accrued prior to the date of purchase. This is a risk, even if the pension and retiree benefits are not described in the current collective agreement, and even if the individuals who are entitled to such benefits are retired prior to closing or otherwise never become employed by the purchaser.

It is imperative that all collective agreements are reviewed early in the due diligence process and that legal advice is obtained to determine the necessity of involving the union as part of the proposed sale process.

No Collective Agreement

If a collective agreement does not exist, it is a matter of negotiation between the parties as to the type of retirement plan or plans the purchaser will provide post-closing to the transferred employees, and how pre-closing accrued pension assets and liabilities are to be addressed. If the sale agreement is silent, the purchaser is free to do whatever it likes. In the case of a sale of assets, the transferred employees' accrued pension assets and liabilities will remain with the seller. In the event of a sale of shares, the pension plan obligations that are in place in the target company will remain there after the sale of the shares of the target company.

In a typical asset purchase deal, the seller will try to obtain a covenant from the purchaser to offer employment to the seller's employees on terms and conditions that are substantially similar in the aggregate to those enjoyed by these employees immediately prior to the closing date of the asset sale. Inferior offers increase the likelihood that the affected employees will not accept the purchaser's offers and that the purchaser's plans may not qualify as a successor pension plan as discussed above. Any resulting severance liabilities will be to the seller's account, unless the asset purchase agreement provides otherwise.

In some cases, the seller may require the purchaser to provide pension benefits which are substantially similar to those provided by the seller to the transferred employees. If the purchaser agrees to meet this requirement, it must be careful as to how this promise is worded in the sale agreement and in its communications to the transferred employees. For example, if the seller's plan provides members with rights to surplus in the plan and the purchaser promises to provide substantially similar pension benefits, the seller and/or transferred employees could argue that the transferred employees are entitled to the same surplus rights in the purchaser's plan (even if the purchaser's plan does not provide for it).

It should be noted that in Quebec, because most corporate transactions will result in the transfer of employment agreements, the purchaser will almost invariably be obligated to provide pension benefits which are substantially similar to those provided by the seller to the transferred employees, subject to constructive dismissal rules.

Due Diligence

A purchaser should request copies of as many pension plan disclosure documents as possible, including:

1. current and historical plan texts, funding agreements (i.e. trust agreements, insurance contracts), employee communications, and all amendments thereto;
2. actuarial valuation reports and cost certificates;
3. collective agreements;
4. recent financial statements;
5. investment policies;
6. funding agent and investment manager reports;
7. correspondence from regulators dealing with material issues; and
8. legal opinions obtained regarding plan terms, such as the right to take contribution holidays and to charge expenses to the plan assets.

The intent of any due diligence process should be to determine how the seller's pension plan(s) is structured and administered, and how the assets are invested. It should also identify contribution and administration costs and liability implications (e.g. unfunded liabilities, outstanding claims by plan members, issues raised by regulators and any promise to employees to increase the pension benefits offered).

Ideally, if a purchaser is proposing a post-closing for the purpose of withdrawing surplus from the seller's/target's pension plan, or using such surplus for contribution holidays or to offset a deficit in another pension plan of the purchaser, then the purchaser should review all current and historical plan and funding documents of the seller's pension plan to determine if any of these proposed actions are legally permitted. Practically speaking, given the time constraints of, and the limited documentation that is available during the due diligence process, it is very difficult for a purchaser to obtain a legal opinion on these proposed actions. If that is the case, the purchaser should not simply assume, when putting together its bid for the business, that any of these proposed actions can be carried out (especially since in the case of employer surplus withdrawals and pension plan mergers, regulatory approval would be required post-closing and may not necessarily be obtained). Furthermore, as noted above, the terms of the collective agreement that are applicable to the target employees would impact the post-closing pension plan arrangements.

With respect to funding issues in a DB plan that are identified in the due diligence process, the purchaser should consult with its own actuary for additional information and assistance. For due diligence relating to DC plans, some of the concerns, among others, would be the manner in which plan members have been advised of their investment choices, whether sufficient investment choices were provided, the manner in which the target company monitored the performance of the investment options offered and selected by plan members, and whether the investment options were permitted under applicable laws.

Within the past 12 months, we have seen the U.K. Pensions Regulator take action to impose liability on Canadian companies that were heavily involved in the operation of U.K. affiliates that operated drastically underfunded pension plans. Similarly, ERISA in the U.S. contains provisions that would enable the U.S. Pension Benefits Guarantee Corporation to seek damages against Canadian companies that participate in an ERISA defined control group that contains underfunded U.S. pension plans. Given the rising reliance on these "long-arm" laws by the U.S. and U.K. pension regulation and guarantee entities, a potential purchaser should carefully consider the involvement of any Canadian entity in the control or direction of U.S. or U.K. affiliates that sponsor pension plans.

Representations and Warranties

In addition to the due diligence process, the representations and warranties regarding the pension plan of the seller are important in protecting the purchaser, if a pension plan or any of its assets and liabilities are to be assumed. For example, a purchaser will typically seek, at minimum, representations and warranties that: the target company's pension plan has been registered, administered and invested in compliance with all applicable laws; all contributions are up to date; there are no funding deficiencies (for a DB plan, either on a going concern or a solvency basis); and the target company does not participate in a multi-employer pension plan.

From a purchaser's point of view, the type of representations and warranties that a seller might give will also depend on whether it has a DC or DB plan. The representations and warranties should survive closing as pension issues, if any, will likely not be identified for months (if not years) after closing. Subject to any limitation periods (legislated or otherwise), in the event of unwelcome surprises, the purchaser should attempt to retain recourse against the seller for any inaccurate representations and warranties given by it, for as long as possible after the closing.

Purchase or Sale of a Business

The pension implications that arise in the context of a purchase or sale of a business will depend on whether shares or assets of the target company are being acquired.

Asset Purchase

When a seller corporation with a pension plan sells assets of its business, there are various options available in dealing with the pre- and post-closing pension arrangements. Each option has different risks and implications for both the purchaser and the seller.

The options are as follows:

1. the purchaser does not provide a successor pension plan ("No Successor Plan Option");
2. the purchaser provides a successor pension plan (either a new or an existing plan) to the transferred employees, but does not assume or transfer to the successor pension plan any accrued assets or liabilities from the seller's pension plan in respect of the transferred employees ("Successor Plan Option - No Transfer");
3. the purchaser provides a successor pension plan (either new or existing) and transfers the accrued assets and liabilities relating to the transferred employees from the seller's pension plan to the successor plan ("Successor Plan Option - With Transfer"); and
4. the purchaser assumes full sponsorship and administration of the seller's pension plan ("Plan Assignment Option").

There are several issues that impact which options are available and preferable to the seller and the purchaser, including the following:

1. Is there a collective agreement, and if so, what does it require?
2. What kind of pension plan (DB or DC) does the seller have? What type of plan does the purchaser have?
3. Is the seller planning to retain any of the employees who currently participate in its registered pension plan?
4. What is the composition of membership in the seller's plan? Are most of the liabilities attributable to retirees and deferred vested members, or to active employees who will be transferred to the purchaser?
5. Is the seller's plan in deficit or surplus?
6. If the seller's plan is in deficit, will the purchaser require the seller to fully fund the plan before closing if the purchaser is considering assuming the plan? If not, can the purchaser obtain a discount on the purchase price?
7. Is the cost of funding the seller's pension plan on an ongoing basis appropriate for the purchaser if the plan is assumed?
8. If there is surplus in the plan, can the surplus be applied to take contribution holidays or withdrawn if the plan is assumed (As mentioned, it is difficult for a purchaser to answer this question within the due diligence period.)?
9. What are the current retirement and benefit arrangements of the purchaser? If the purchaser already has a pension plan, will the assumption of the seller's plan create duplication and additional administrative burdens and costs for the purchaser?
10. Is there any language in either the seller's or the purchaser's pension plan and funding documents that would prohibit the transfer of assets from the seller's plan to the purchaser's plan and the co-mingling of such assets? Is there a risk that such a transfer would not be approved by the regulator, as discussed below?

Analysis of Options

No Successor Plan Option

This option is not available if a registered pension plan is required pursuant to a collective agreement. Even if no collective agreement exists, this option may pose severance cost risks for the seller if the purchaser's offers of employment do not provide substantially the same terms and conditions of employment in the aggregate as those provided by the seller immediately before closing. This is especially true in Quebec, where most corporate transactions will result in the transfer of employment agreements.

As pointed out above, the seller is at risk of being ordered by the pension regulator to partially or fully wind-up its pension plan if no successor pension plan is provided by the purchaser (e.g. if the purchaser chooses to provide a group RRSP instead). Once partial wind-ups are removed from Ontario legislation, severance costs will include the same grow-in benefits that an Ontario member would be entitled to if there had been a partial wind-up.

Successor Plan Option - No Transfer

In this case, on retirement, a transferred employee would receive his or her pension payments from two sources: the purchaser's plan and the seller's plan (or an insurance company if an annuity was purchased by the purchaser or seller). The seller continues to have control and obligations in respect of the pre-closing assets and liabilities relating to the transferred employees, and the responsibility for administering and investing those assets.

For purposes of benefit accrual in a DB plan, the purchaser's plan can either recognize service and salary from the closing date only ("post-closing service approach"), or recognize the employee's combined service and salary with both the seller and the purchaser, but require an offset for the benefit payable from the seller's plan (the "wrap-around approach"). The deemed continuous employment and plan membership requirements under pension legislation does not apply to benefit accrual and a wrap-around approach is not required. The impact on the employee's overall pension benefit under these two approaches will vary depending on the type of DB plans provided by the purchaser and seller. However, in a final average earnings plan, the transferred employee would definitely be disadvantaged under the post-closing service approach as the pre-closing service benefits would be calculated using the earnings of the employees as of the closing date, without taking into account salary increases provided by the purchaser.

Under the "wrap-around" approach, higher initial funding obligations would be created for the purchaser (actuarial input should be obtained). The purchaser may want to take this added funding cost into account when negotiating the overall purchase price of the deal, if the "wrap-around" approach is being considered by the parties. Also, it is important to distinguish between what is payable in accordance with the seller's plan and what is paid, in case the seller becomes bankrupt. The purchaser would not want to be obliged to make up for any shortfall or non-payment from the seller's plan.

As noted earlier, if there is no transfer of assets and liabilities to the purchaser's plan, there is a risk that a wind-up might be ordered by the pension regulator.

Successor Plan Option - With Transfer

Under this option, upon retirement employees would receive one cheque from the purchaser's plan (or an insurance company). Also, it allows the purchaser to have control over the pre-closing and post-closing pension assets of the transferred employees, rather than leaving the control of the pre-closing assets with the seller.

In the case of DB plans, there are generally two ways to determine the value of assets to be transferred from the seller's plan to the purchaser's plan. Under the first approach, the parties could agree that assets in an amount equal to the liabilities relating to the accrued benefits of the transferred employees be transferred. The second approach is to transfer the proportion of assets in the seller's plan that is equal to the same proportion by which the transferred employees' liabilities compare to the overall liabilities of the seller's plan. In this second scenario, a proportionate amount of any surplus or of any deficit would also be transferred to the purchaser's plan. In Quebec, this second approach is required by pension legislation. There are also currently cases before various provincial courts that may require a transfer of existing surplus if there is a transfer of assets.

Adjustments to the purchase price could be negotiated to account for any deficits or surplus. In this regard, it should be kept in mind that just because surplus might be transferred over to the purchaser's plan, the purchaser may not necessarily have the legal right to use it for contribution holidays or to withdraw it. Thus, there is a risk that the surplus transferred (which may have translated into a higher overall purchase price for the purchaser) may not end up having any practical value to the purchaser. In many jurisdictions, surplus withdrawals by employers are permitted only if authorized under the plan documents and/or a certain number of plan members consent to the proposed surplus withdrawal. In all cases, regulatory approval of the proposed surplus withdrawal is also required. In short, the withdrawal of surplus from a registered pension plan by an employer can be difficult (and in some cases, impossible) to effect. It is usually a costly and lengthy process.

Another important issue in the determination of the transfer amount is the basis on which the liabilities are calculated. The parties should, in the sale agreement, agree on whether the transfer amount will be determined using liabilities calculated on a going concern basis, on a solvency basis or the higher of the two. The going concern financial position of a pension plan is determined based on the assumption that the plan will continue indefinitely into the future (e.g. it assumes increases in earnings). The solvency financial position is determined by comparing the market value of assets to the liabilities, for benefits earned prior to the valuation date, calculated as though the pension plan had been terminated on the valuation date (e.g. earnings are frozen and all plan members are fully vested). The liabilities and funded status of the seller's plan could be drastically different, depending on whether the calculations were made on a going concern or a solvency basis.

For DB plans, an actuarial report would have to be prepared outlining the assumptions used to calculate the amount of assets and liabilities being transferred. The transfer amount can be contentious if, for example, the purchaser's actuary does not agree with the assumptions and the calculations used by the seller's actuary. It is typical to see lengthy provisions in the purchase and sale agreement to address what would happen if there is a disagreement amongst the actuaries, who the arbitrator will be, and also what would occur if the agreed-upon transfer amount is not approved by the regulator.

Transfers of assets and liabilities between two DC plans are much simpler to deal with. Essentially, the transferred employees' account balances as of the closing date, adjusted for net earnings thereon (and any expenses charged to such accounts) from the closing date to the actual transfer date, would be transferred to the purchaser's DC plan. The surplus or deficits (provided that contributions under the seller's plan are up to date as of the closing) are usually not at issue with transfers involving DC plans (although an exception could arise if the DC plan had been converted from a DB plan with surplus). Forfeited contribution amounts, if any, should be addressed. It is uncommon to see agreements between purchasers and sellers involving a transfer of assets and liabilities from a DB plan to a DC plan or vice versa.

In an asset transfer situation (DB or DC), the sale agreement should indicate how the transferred assets are to be administered and invested while waiting for regulatory approval, and who will bear the administration expenses during the waiting period. The agreement may also dictate whether the assets ultimately transferred will be in cash and/or in-kind.

A transfer of assets and liabilities from a seller's pension plan to a purchaser's pension plan requires written approval from the pension regulator. Each jurisdiction has its own policies in respect of proposed asset transfers. For example, in Alberta, if there is a surplus in the seller's DB plan and the surplus is not transferred as part of the asset transfer, the transferred members retain any rights they may have had to the surplus in the seller's plan, even though they are no longer employed by the seller and their assets and liabilities have been transferred out of the seller's plan.

Plan Assignment Option

If sponsorship of the seller's plan is assigned to the purchaser, the assets and liabilities of the entire plan (i.e. relating to active members, retirees, terminated members with deferred vested benefits, beneficiaries) are assumed by the purchaser. Thus, the purchaser could end up administering the benefits of individuals with whom they have no prior relationship. The purchaser should include language in the agreement of purchase and sale to the effect that the purchaser will not be responsible for liabilities in respect of the administration or operation of the plan prior to closing. Strong indemnities regarding pre-closing administrative errors should be included to protect a purchaser from these liabilities. From the perspective of the regulator and the plan members, the purchaser would likely be seen as the entity responsible for both pre- and post-closing obligations and liabilities regarding the assigned plan, regardless of any language favouring a purchaser's interest incorporated into the agreement of purchase and sale.

The assignment of sponsorship and administration of the seller's plan does not require regulatory approval, although the appropriate amendments to the plan (and related documents, such as excerpts of the sale agreement, the pension assignment, or the assumption agreement, if any) will have to be filed with the pension regulator and CRA for registration.

This assignment option is not feasible if the seller is retaining some of the employees who are members of that plan (unless those retained employees are removed from the plan prior to closing). In addition, if the seller's plan participates in a pooled investment arrangement with other plans of the seller or its affiliates (e.g. master trust arrangement), such participation should be terminated prior to the effective date of the assignment of the plan from the seller to the purchaser.

Share Purchase

When shares of a target company are sold to the purchaser, the target's employment contracts and all its pension and benefit plans remain unaffected.

In general, no amendments, regulatory filings or other actions are required in a share sale with respect to the pension plan, as the target company remains the sponsor and administrator of the plan. Similarly, if the target company participates in a multi-employer pension plan ("MEPP"), its contribution obligations to the MEPP would also continue. There are some exceptions to this general rule.

The following are examples of pension issues that may be relevant in a share purchase.

Related Companies Participate in Target Company's Pension Plan

If companies related to the target company are not part of the share acquisition, it is necessary to terminate their participation in the target company's pension plan as of the closing date. Otherwise, post-closing, companies unrelated to the buyer will participate in the target company's pension plan. Not only is this undesirable, but it will also cause the plan to fall under unique pension legislative requirements applicable to MEPPs. Among other things, MEPPs have significantly different administration rules under the pension legislation than those which apply to single-employer pension plans.

The pre-closing treatment of the accrued assets and liabilities of the employees of the related company will also have to be addressed. For example, the parties will have to decide if such assets and liabilities should remain in the target company's pension plan or be transferred into a successor plan of the related company.

Assets of the Target Company's Pension Plan Participate in a Master Trust

Where the target company is related to other Canadian companies with pension plans, it is common for assets of the target company's pension plan to be co-mingled with assets of other pension plans sponsored by the seller or other related companies for investment purposes. These are referred to as master trust arrangements.

In this situation, the assets of the target company's pension plan will have to be extracted from the master trust arrangement before closing. This may lead to negotiations between the seller and the purchaser as to the valuation of that portion of the master trust assets attributable to the target company's pension plan, and the means by which such assets are to be distributed from the master trust (e.g. in cash or in kind or both).

Target Company is a Participating Employer in the Pension Plan of a Related Company

The target company in an acquisition may be a "participating employer" in a pension plan that is controlled by a company that is not part of the acquisition. The target company must take steps to terminate its participation in the seller's pension plan, or the plan of the related company, as of the closing date. The issues that arise in this scenario are similar to those applicable to an asset sale scenario. For example, what kind of retirement plan will the target company provide to its employees post-closing?

Purchaser Requires Termination of Pension Plan

A purchaser could negotiate this provision into the sale agreement if the purchaser prefers to add the target company's employees into its own existing pension and benefit plans post-closing (e.g. for economies of scale). This approach will, of course, be subject to the provisions of any applicable collective agreements.

Mergers

When two companies amalgamate, all assets and liabilities of the two amalgamated companies will continue in the amalgamated company ("Amalco"). However, the pension plans of the two merging entities do not automatically merge just because the two companies themselves have merged. Each of the plans will continue to exist separate and apart from the other unless Amalco takes steps to merge the plans. As a result, Amalco may end up with more than one pension plan and all employees of the two amalgamated entities (both current and new) may end up being entitled to participate in one or more of Amalco's plans because they may meet the definition of "employee" or "member" in more than one Amalco pension plan. For this reason, it is important for Amalco to take steps to amend its pension and other benefit plans prior to, or on, the amalgamation date to clarify which Amalco employees should participate in which plans (i.e. depending on their location, job description, division, etc.). Amendments should also be made to all of Amalco's plans no later than the date of the amalgamation.

If Amalco wishes to merge the pension plans of the two merging entities, regulatory approval will be required. As noted above, such approval may be difficult to obtain. Before merging pension plans, the pre-merger plan and funding documents (both historical and current) must be reviewed in order to determine if a merger is legally permitted. Accordingly, a legal opinion should be sought before any steps are taken to merge two pension plans.

Other Benefits/Costs Issues of Note

In addition to a registered pension plan, the target company likely provides a variety of other benefit arrangements for its employees. Although it is not possible to address all such benefit arrangements here, retiree benefits and supplemental executive retirement plans ("SERP"), also called "top-up plans," are briefly addressed below.

Retiree Benefits

In the due diligence process, it is important for a purchaser to determine whether the target company provides retiree benefits to its current retirees and if such benefits have been promised to current employees upon their retirement, pursuant to either a collective agreement, employment contract or employee communications. With respect to existing retirees, unless the right to change or terminate the retiree benefits was reserved by the target company and such right was properly communicated to the retirees while they were employed (i.e. prior to retirement), the target company may not change or terminate these benefits, as they are usually "vested" in the retirees.

In a share transaction or merger, retiree benefit liabilities will remain with the target company. Similarly, if the current employees have been promised retiree benefits by virtue of a collective agreement, employment contract or employee communications, the obligation to provide such benefits would be attached to the target company. The target company's ability to change or terminate the benefits for future retirees in respect of unionized current employees will depend on negotiations with the union, and in respect of the non-unionized current employees, whether or not the target company reserved the right to change or terminate its promise, if any, and if such a right was properly communicated to such non-unionized employees.

In an asset deal, the purchaser may be required to provide retiree benefits to the transferred employees due to a collective agreement, or the seller may be required to provide substantially similar salary and benefits in the aggregate to the transferred employees by the purchaser.

SERPs or "Top-Up Plans"

As noted above, the Act imposes a limit on the maximum benefits that can be provided under a DB plan. Some employers promise to provide employees with the amount of pension the individual would have otherwise received under a DB plan, but for the limit in the Act (it is less common to see top-up plans for DC plans). The pension benefit amount exceeding the limit in the Act (the "top-up benefit") is usually provided pursuant to a SERP (or simply via an employment contract, which is referred to as a SERP for discussion purposes). Top-up benefits are not legislated under pension legislation at this time and can be either funded or unfunded. If a SERP is funded, certain rules in the Act apply.

SERP liabilities can be costly and may not be easily discernible from the due diligence process, since they are not subject to legislative requirements to prepare actuarial valuation reports. Questions that a purchaser should ask include whether it is funded, how it is funded, if there is a deficit, the number of participants and the costs of fulfilling the SERP promises. Again, if the seller provides a SERP, the purchaser in an asset deal may be required by the seller to provide the same kind of arrangement post-closing.

MEPPs: Multi-Employer Pension Plans

Many Canadian employers participate in MEPPs pursuant to collective agreement obligations, or simply because they are attracted to these arrangements where they do not have any obligations to administer the plan. MEPPs are administered by boards or individual trustees. They are less common in non-unionized workforces.

In the last few years, there have been several surprising and significant lawsuits and regulatory prosecutions launched in respect of MEPPs. The surprising element has been the alleged liability of the participating employers who had the impression that their liability in respect of the MEPP in which they participated, was limited to the amount of contribution they promised to make to the MEPP, as set out in the collective agreement. That may not be the case. With the exception of Quebec, pension legislation across Canada allows benefits under a MEPP to be reduced in the event of a termination of the MEPP in circumstances where there is a deficit. The plan documents, however, must allow this.

In litigation referred to as the "Participating Co-Ops" litigation (Financial Services Tribunal of Ontario, File Number P0275-2006), the Ontario pension regulator took the position that the participating employers were liable for the deficit in a terminated MEPP due to specific wording in the MEPP documents. In other litigation referred to as "CCWIPP" (Ontario Superior Court of Justice, File Number CV-06-CV324987-0000), plaintiffs in a $2-billion representative action took the position that certain participating employers were liable for the consequences of alleged poor investment decision-making. That litigation recently settled.

Purchasers of a business should be aware that although the target company may genuinely believe that it has no liability in respect of the MEPP in which the target company participates, that belief may not be upheld by the courts. Accordingly, purchasers should seek representations and warranties that there are no MEPPs or, alternatively, if there is a MEPP issue, that the MEPP has been administered in accordance with applicable laws and permits the reduction of benefits in the circumstances of a deficit.

Conclusion

Canadian pension law allows claims to be pursued by regulators, unions and employers, notwithstanding releases. Often, there is no limitation period. The financial and reputational risks associated with pensions can be enormous. Fraser Milner Casgrain LLP has deep and extensive experience in dealing with those risks. We can identify and attempt to avoid or limit them.

About FMC

Fraser Milner Casgrain LLP (FMC) is one of Canada's leading business and litigation law firms with more than 500 lawyers in six full-service offices located in the country's key business centres. We focus on providing outstanding service and value to our clients and we strive to excel as a workplace of choice for our people. Regardless of where you choose to do business in Canada, our strong team of professionals has extensive knowledge and expertise on regional, national and cross-border matters. FMC's well-earned reputation for consistently delivering the highest quality legal services and counsel to our clients is complemented by an ongoing commitment to diversity and inclusion to broaden our insight and perspective on clients' needs.

Our Approach

At FMC, we understand the complexities posed by changing market conditions. We know that to serve your needs effectively, we must understand your business and objectives in a broad context in order to anticipate developments, identify opportunities and respond to challenges.

FMC prides itself on being able to deliver effective solutions which advance the strategic interests of its clients. We do this by combining and leveraging our diverse professional capabilities and strong business acumen, with a clear understanding of our clients' needs and priorities.

We believe, first and foremost, that our success is tied directly to the success of our clients. As such, our approach is client-focused and results-driven. We offer pragmatic advice and our effort is a collaborative exercise, led by the appropriate partner and assisted by the appropriate professionals.

Experience Worth Pursuing

Our Mergers and Acquisitions Group acts on takeover bids (hostile and friendly), amalgamations, arrangements, and other business combinations involving public or private companies, as well as share and asset purchases and joint ventures. Our firm provides innovative and sophisticated advice on all matters arising in connection with M&A transactions, including tax, competition, *Investment Canada Act* compliance, financing, environmental, government relations, employment, pension and intellectual property law. We provide strategic advice, prepare all documents, and appear before securities commissions and courts whenever challenges need to be made or defended.

Success in hostile and friendly takeover bids is often more a matter of innovative approach than application of conventional legal procedures. Our experience allows us to move quickly and efficiently to assure the best outcome for our clients. We know the players; we know the regulators; and we know how to structure a successful transaction. With offices across the country, industry expertise in Canada's principal business sectors, lawyers who have worked for the regulators and experts in relevant practice groups like tax, competition, foreign investment and litigation, we know how to get the deal done.

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