

# GOING PRIVATE TRANSACTIONS IN CANADA A Primer for Private Equity Investors

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July 6, 2004

## Introduction\*

A going private transaction is a transaction or series of transactions which has the effect of transforming a public company into a private company and thereby eliminating the public shareholders.

A going private transaction is typically proposed for one of two reasons:

- (i) the management of the target company or one or more shareholders of the target company wants to buyout the other public shareholders and take the company private; or
- (ii) a third party proposes to acquire the target company either with or without the support of management or a group of shareholders.

The first type of transaction is often referred to as a management buyout or MBO. Each of the types of transactions is often referred to as a leverage buyout or LBO, as the bidder will often incur a significant amount of debt (taking advantage of the assets and credit rating of the target company as collateral) in structuring the going private transaction. In either case, these types of transactions represent a good opportunity for private equity investors. Buyout funds often provide all or a significant portion of the equity financing and mezzanine funds often provide the subordinated debt required to support the going private transaction.

This paper is intended to provide an overview to private equity investors of the current marketplace for going private transactions in Canada and the basic considerations that both private equity investors, the target company, its management, directors and shareholders will have to take into account in pursuing a going private transaction.

## Why Go Private?

### Increased Interest in Going Private Transactions

In recent years we have witnessed a significant increase in the number of companies in the United States and Canada interested in pursuing going private transactions. One study noted that in the United States the number of going private transactions increased from 197 in 2000 to 316 in 2002.<sup>1</sup> Another study noted that the number of public companies that have announced plans to go private increased by more than 30% in the five fiscal quarters since the passage of the *Sarbanes-Oxley Act* as compared to the same period prior to its passage.<sup>2</sup> The same study also found a significant increase in companies considering

\* Thank you to Garth M. Girvan, Robert D. Chapman and Carrie Williams for assistance.

<sup>1</sup> "Going Private Becomes Attractive", Fulcrum Financial Inquiry, LLP (November 2003).

<sup>2</sup> Thompson Financial.

going private. While the trend appears to be focused primarily on small and midsize public companies, a number of larger companies have recently pursued going private transactions in the United States.

In Canada, we have seen a number of high profile going private transactions in the recent past including, Corel Corporation, CARA Operations Limited and TD Waterhouse.

Analysts and commentators have suggested there are a number of factors that have contributed to this increase:

1. Depressed Share Prices The late 1990s saw a significant boom in the number of companies going public and a substantial increase in stock market prices. With the subsequent decline in the public markets many of the smaller public companies have had trouble justifying the costs associated with being public.
2. A Caustic Environment Corporate scandals in the United States, Canada and elsewhere have created a more caustic environment for public companies as well as their directors and officers. Regulators are more vigilant in pursuing potential offenders and we have seen a growth in class action litigation brought on behalf of minority shareholders.
3. Increased Regulation Resulting in Increase Cost The cost and complexity related to being a public company has increased significantly as a result of the passage of the *Sarbanes-Oxley Act* in the United States. In Canada, the Canadian Securities Administrators have recently adopted a number of significant new national instruments and other rules<sup>3</sup> mandating (i) enhanced continuous disclosure, (ii) certification of financial statement, disclosure controls and procedures and internal controls, and (iii) enhanced audit committee and auditor oversight requirements. In addition, a number of securities regulatory authorities in Canada recently proposed new multilateral instruments mandating corporate governance disclosure requirements.<sup>4</sup> These changes are expected to result in a similar increase in the cost of being a public company in Canada.
4. Out of Sight – Out of Mind If an issuer's stock has declined and fallen out of favour it will most likely be more thinly traded. Most likely there will be no or very limited analyst coverage on the stock and limited interest in the stock from institutional investors. A company in this situation will likely have very limited access to markets to raise additional capital. It will also be hampered in its ability to use its stock as currency to expand and pursue acquisitions.

## The Increasing Cost of Being Public

In the United States according to one study, the average cost of being a public company has nearly doubled since the passage of the *Sarbanes-Oxley Act*<sup>5</sup>. Despite some predictions that the overall cost increases associated with corporate governance reform were a one time event in the United States,

<sup>3</sup> National Instrument 51-102 – Continuous Disclosure Obligations, National Instrument 71-102 – Continuous Disclosure and Other Exemptions Relating to Foreign Issuers; National Instrument 52-108 – Auditor Oversight; Multilateral Instrument; National Instrument 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings; 52-110 – Audit Committees.

<sup>4</sup> Multilateral Instrument 58-101 – Disclosure of Corporate Governance Practices; Multilateral Instrument 58-201 – Effective Corporate Governance and Multilateral Instrument 51-104 – Disclosure of Corporate Governance – A Modified Approach.

<sup>5</sup> “The cost of being public in the era of the *Sarbanes-Oxley Act*”, Foley & Lardner LLP.

according to the same study, associated costs have continued to increase each year since introduction of the reforms.

We are not aware of a similar study in Canada. However, roughly 50% of the companies in the S&P/TSX Composite Index<sup>6</sup> have securities listed in the United States. These companies have already experienced the increased costs associated with the US corporate governance reforms to some degree. In addition, there is strong anecdotal evidence that public companies in Canada are experiencing similar cost increases as a result of recent changes in Canada.

There are considerable costs associated with simply maintaining a public company. These include:

- (i) the costs of producing quarterly and annual financial statements, reporting on management's discussion and analysis on financial statements, holding annual meetings of shareholders and making other requisite filings with regulatory authorities;
- (ii) costs associated with retaining and compensating directors given the perception of greater exposure to liability in the public company context;
- (iii) costs associated with auditors, law firms and other professional advisors;
- (iv) costs associated with an investor relations department to maintain contact with investors, regulatory bodies and others within the financial community;
- (v) fees payable to securities regulators and stock exchanges; and
- (vi) premiums for directors and officers liability insurance.

## Other Possible Benefits of Being Private

In addition to the reasons discussed above, there are some less quantifiable reasons for a company to go private. For example, senior management of a public company is often focused on the next quarter's results and other disclosure and compliance requirements. This can draw attention away from managing the business. As a private company, management is potentially less distracted from long term goals and can better concentrate on its operations.

In addition, a going private transaction can provide liquidity to the public shareholders of the target company. This will be particularly relevant if the company is thinly traded or has limited analyst coverage. Often the going private transaction is at a premium to recent market prices.

Some private equity investors suggest that going private will provide the target company and its management with access to financial and operational expertise that it may not have access to as a public

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<sup>6</sup> Standard & Poor's Corporation.

company. Many private equity investors then draw upon internal and external advisors to assist in the expansion and growth of the target company once it is private.

Further, a public company with a low price to earnings ratio might become targeted by possible buyers. Management of a non-controlled public company may consider taking the company private before it becomes a possible take-over candidate.

Of course, a going private transaction will put the non-controlled public company “in play”. This may precipitate bids from others so the board of directors will have to weigh this factor. A recent transaction involving Pivotal Corporation, a Vancouver-based enterprise software company, provides a good example. Following a confidential auction process beginning in early 2003 with a select qualified bidders, Pivotal, with the support of certain shareholders, entered into an agreement with Oak Investment Partners to take Pivotal private by way of plan of arrangement and combine it with Talisma Corp., a company controlled by Oak Investment Partners, in October 2003. Subsequent to the announcements of this proposed transaction two additional bidders publicly made offers for Pivotal. Ultimately, Pivotal was acquired not by Oak Investment Partners but by CDC Software of Hong Kong in February 2004.

## **Are You Sure You Don't Want to Remain Public?**

Before pursuing a going private strategy management should take into account certain disadvantages in being a private company. Once it is no longer public a company will not have the same access to public markets for financing itself in the future. Management should take into account any growth and expansion plans and how it proposes to access capital and whether these restrictions put the company's plans at risk.

Once the company is private the remaining shareholders will no longer have a clear path to liquidity. If the company's plans include making acquisitions it should take into account whether its ability to do so will be diminished if it does not have access to the public markets or cannot use its equity as currency in such acquisitions. Further, management and other employees who hold stock options will have to be compensated in other ways in a private company.

Going private transactions can be expensive, complex and time consuming. Legal, accounting and financial advisory fees can add up quickly. The company's plans will be under scrutiny at many levels from board of directors, special committee and shareholder approval, to formal valuations by third party financial advisors, to possible applications to regulatory authorities for discretionary relief.

The chart below shows some of the major milestones for two recent going private transactions in Canada.

**Corel Corporation**

March 24, 2003	Non-Disclosure and Standstill Agreement <sup>7</sup>
June 6, 2003	Acquisition Agreement
July 16, 2003	Interim Order – Plan of Arrangement
July 28, 2003	Mailing of Proxy Circular
August 20, 2003	Securityholders Meeting
August 22, 2004	Final Order – Plan of Arrangement
August 26, 2003	Closing

**CARA Operations Limited**

June 13, 2003	Cara Holdings confirms intent to propose a going private transaction
August 15, 2003	BMO Nesbitt Burns presents preliminary valuation (range of \$7.25 to \$8.50 per share)
August 29, 2003	Cara Holdings proposes going private transaction at \$7.50 per share
November 7, 2003	Air Canada repudiates it catering agreement with CARA
November 24, 2003	BMO Nesbitt Burns presents a revised valuation (range of \$7.00 to \$8.25 per share)
December 9, 2003	CARA announced amended catering agreement with Air Canada
December 17, 2003	Cara Holdings announces going private transaction at a price of \$7.625 per share
February 3, 2004	Special meeting of shareholders adjourned
February 6, 2004	Cara Holdings announces increase to \$8.00 price per share. Jarislowsky Fraser Ltd. confirms its support
February 24, 2004	Special meeting of shareholders approves the proposed going private transaction
February 25, 2004	Closing

If you are considering a going private transaction by way of amalgamation or plan of arrangement you should assume that it will take at least six months to complete once you make the decision. This of course assumes that the process goes smoothly and there are no pot holes in the road. A contentious deal may take much longer. A going private transaction by way of take-over bid can be accomplished in a shorter period if 90% of the shares are tendered to the bid. This can be accomplished in approximately

<sup>7</sup> Unusual for a public company

60 days. If a related party is making the bid you should allow for an additional three weeks for the preparation of a formal evaluation. The procedures are discussed in further detail below.

A company considering a going private transaction should also take into account the potential risk of litigation from disgruntled minority shareholders.

## The Regulatory Framework

Going private transactions involve an interplay of both corporate and securities laws. The effect of the transaction in each case is that some shareholders will have their interest in the target company cashed out (or occasionally converted to a shareholding in the parent acquirer) without the holder's consent. Applicable corporate and securities laws do not prohibit going private transactions but instead place restrictions and obligations on the bidder, the target company and related parties engaging in a going private transaction. From a policy perspective, they are intended to safeguard the interests of minority shareholders and ensure that shareholders are treated fairly in the process of a going private transaction.

Corporations in Canada are generally governed by a provincial or the federal business corporations statutes. In order to undertake certain fundamental changes (which would apply in the case of most going private transactions) a corporation must, for each class of outstanding shares, obtain approval from holders of at least two-thirds of the shares represented in person or by proxy at duly called meeting of shareholders.<sup>8</sup> In the case of each fundamental change which gives rise to a shareholder vote a corporation is also required to grant each shareholder a dissent or appraisal right.<sup>9</sup> In addition, under applicable business corporation statutes a shareholder may look to the oppression remedy which provides courts with a laundry list of remedies where the conduct of a target company has been oppressive or unfairly prejudicial to or is unfairly disregards the interests of its shareholders, directors, officers or creditors.<sup>10</sup> These rights are discussed in further detail below.

Applicable provincial securities laws in Canada regulate take-over bids.<sup>11</sup> In addition, under Rule 61-501<sup>12</sup> the Ontario Securities Commission (the "OSC") imposes additional requirements on insider bids and business combinations which apply in the context of many going private transactions. This rule and Companion Policy 61-501 were recently amended by the OSC and became effective on June 29, 2004. It should be noted that Rule 61-501 applies not only to going private transactions involving corporate

<sup>8</sup> For example, *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as amended ("CBCA"), s. 176 and *Business Corporations Act* (Ontario), R.S.O. 1990, c. B.16, as amended ("OBCA"), s. 170.

<sup>9</sup> For example, OBCA, s. 185; CBCA, s. 190.

<sup>10</sup> For example, OBCA, s. 248; CBCA, s. 241.

<sup>11</sup> For example, *Securities Act* (Ontario), R.S.O. 1990, c. S.5, as amended, Part XX.

<sup>12</sup> The *autorité des marchés financiers* in Quebec also regulates going private transactions.

issuers but other entities as well such as partnerships and trusts.<sup>13</sup> The scope of this discussion is limited to corporations.

The OSC regards it as essential, in connection with insider bids, business combinations and other related party transactions, that all security holders be treated in a manner that is fair and that is perceived to be fair. To this end, securities regulation (i) generally mandates equal treatment of shareholders, (ii) requires additional disclosure regarding the background and approval process undertaken by a target company which are intended to focus the board of directors on their fiduciary duties, (iii) requires minority shareholder approval in certain instances, and (iv) in some cases, requires independent valuations.

## Techniques for Going Private in Canada

In Canada, a going private transaction can take a number of forms. The most common ones:

1. an amalgamation of the target company with the party pursuing the going private transaction or its affiliate;
2. a take-over bid which may or may not be followed by a compulsory acquisition of the shares of those holders who do not accept the bid (subject to certain thresholds) or a second stage going private transaction;
3. a plan of arrangement; or
4. an amendment to the articles of the target corporation.

This discussion will focus only on the first three.

### Amalgamation

An amalgamation is a statutory means of combining two or more companies into a single company. The particular statutory regime will depend upon the jurisdiction of incorporation of the target company. As a going private technique an amalgamation may be used on its own or as the second stage to a going private transaction commenced by take-over bid (discussed below). There are a variety of ways in which a going private amalgamation may be structured but a simple structure is as follows:

- (i) the bidder incorporates a new subsidiary in the jurisdiction of the target company (“Bidco”);

<sup>13</sup> The amendments to OSC Rule 61-501 adopt the term “business combination” in place of “going private transaction”. The term continues to be used in the OBCA. The provisions relating to going private transactions were removed from the CBCA in November 2002 and replaced by a provision that simply requires compliance with applicable provincial securities laws.

- (ii) the shareholders of the target company vote to amalgamate the target company with Bidco;
- (iii) on amalgamation the bidder receives all of the voting shares of the amalgamated company in exchange for its shares in Bidco and all the shareholders of the target company receive redeemable shares in the amalgamated company; and
- (iv) the redeemable shares of the amalgamated company are immediately redeemed for cash or whatever other consideration is agreed upon.

This leaves the bidder as the sole shareholder of the amalgamated company.

The primary document involved in completing a going private amalgamation is a proxy circular prepared and delivered to shareholders of the target company. Under Canadian corporate law an amalgamation is a fundamental change which must be approved by special resolution. This requires that holders of not less than two-thirds of the shares represented in person or by proxy at a meeting of shareholders must approve the amalgamation. If there are multiple class of shares in the target company each class must pass a special resolution. This applies with respect to both voting and non-voting shares. In addition, if the transaction involves a related party of the bidder or the target company a separate approval by a majority of the minority shareholders of the target company may be necessary. This is discussed below in further detail.

One of the benefits of using an amalgamation as a going private technique is that it accomplishes the desired result in a single step. However, it does require a shareholders meeting and if competing bids for the target company arise then a bidder proposing an amalgamation (or other corporate transaction requiring shareholder approval such as a plan of arrangement discussed below) may be at a disadvantage to a bidder proposing a take-over bid. This is primarily due to the fact that once notice of a meeting of shareholders has been delivered, it is difficult, if not impossible, to amend the terms of the proposed amalgamation under consideration at the meeting without restarting the whole notice period for such meeting. Practically speaking, as it requires cooperation from the target company, a hostile bidder cannot use the amalgamation or plan of arrangement approach.

## Take-over Bid

Another technique for pursuing a going private transaction is pursuant to a take-over bid. A take-over bid can be made on a basis where support for the bid is solicited from the target company's board in advance, or it may be unsolicited, in which case if it is not supported by the target board it will be considered hostile. It would be unusual for a going private transaction to proceed by hostile bid if the bidder will want to retain management after the target company becomes private.

In the case of a negotiated take-over, the bidder will typically negotiate lock-up agreements with each of the major shareholders pursuant to which the locked-up shareholders will agree to tender their shares to the proposed bid. In addition, the target will typically enter into a support agreement with the bidder

setting out various obligations of the bidder and the target company required in the context of the transaction. Support and lock-up agreement will also be used in the context of the other going private techniques as discussed in further detail below.

To the extent an offer by the bidder to shareholders of the target company constitutes a “take-over bid” then the bidder will have to comply with certain disclosure requirements and follow certain procedural steps. Generally, an offer will be a take-over bid for the purposes of applicable Canadian securities laws if the offer is to acquire any class of equity securities where the securities subject to the offer, together with the bidder’s prior interest, constitute 20% or more of the outstanding class at the date of the offer. In the case of going private transaction the bid will be for all of the shares.

The take-over bid must remain open for acceptance for a minimum of 35 days. Any extension or amendment to the take-over bid will generally extend the bid by up to an additional 10 days. The bid may be commenced by delivery of the take-over bid circular in prescribed form to shareholders of the target company or by way of published advertisement in at least one national newspaper. If commenced by this second method the bidder must file the take-over bid circular with applicable securities regulators on or before the date of the advertisement and on the same date deliver a request for a shareholders list to the target company. The bid must be mailed to shareholders of the target company within two business days of receipt of the shareholders list.

It is not uncommon for a take-over bid to be subject to various conditions such as Competition Act and other regulatory approvals, however, it should be kept in mind that in Canada a take-over bid may not be conditional on financing so the bidder must have its financing in place prior to commencing the bid. Further, the circular must include a description of the source and terms of the financing.

Most bids in Canada will contain a condition that a minimum number of shares be tendered to the offer. This is so the bidder has a level of comfort that a certain level of approval is obtained before the bidder is required to take up the shares tendered to the bid. If the bidder has more than two-thirds of the outstanding shares of the target company after the take-over bid, generally it may proceed with a second stage amalgamation in order to acquire the shares not tendered to it in the bid. The steps to this second stage amalgamation will generally be the same as discussed above in the context of a single stage amalgamation with certain exceptions. The minority approval requirements (discussed below) still apply in respect of a second stage amalgamation. However, provided certain conditions are met, a bidder can vote the shares acquired through the take-over bid, including any locked-up shares, in favour of the second stage transaction. Any shares held by the bidder prior to the commencement of the bid cannot be voted as part of the minority.

Where the take-over bid is made by an insider (which generally means it is made by or with the involvement of one or more 10% holders, management or directors) a formal valuation and enhanced disclosure will generally be required. The scope of the formal valuation requirements is discussed below.

If the offer is accepted by 90% or more of the securities of the target company not already owned by the bidder then the bidder can take advantage of the compulsory acquisition provisions under applicable corporate law to acquire the remaining shares. The shares of the target company held by the bidder at the date the bid is made are excluded from the 90% calculation. The compulsory acquisition procedure is generally less time consuming and less costly so it is in the bidder's interest to obtain the 90% approval threshold.

Take-over bid rules in Canada also place restrictions on pre-bid and post-bid actions on the part of the bidder. Generally, if the bidder acquires shares from one or more shareholders of the target company within 90 days prior to making the take-over bid the bid must be an offer to acquire all shares of the target company at a price not less than the price paid in such private transaction. Further, the bidder may not acquire shares of the target company subject to the bid by way of transaction not on the same terms as the bid for the 20 days after the date of it. As well, applicable securities laws require each person who acquires beneficial ownership or control or direction over shares representing 10% or more of an outstanding class of a target company to file what is commonly referred to as "early warning" report. A subsequent report is required upon acquisition of an additional two or more percent of the shares of the target company.

It is not uncommon for a significant number of shareholders of a Canadian public company to be resident in the United States. Accordingly, it will be necessary to assess the U.S. securities laws which may apply in respect of a going private transaction in Canada. The Multijurisdictional Disclosure System<sup>14</sup> provides a regime that permits a bidder to make a take-over bid for a Canadian target company that has U.S. resident shareholders in compliance with Canadian take-over bid rules rather than U.S. take-over bid rules provided certain conditions are met. This allows the bidder and the target company to avoid complying with two sets of potentially different procedures (both Canadian and U.S.) as well as the potentially significant expense associated with dual compliance. There are a number of eligibility requirements which must be met including the following: (i) the target company must be Canadian, (ii) less than 40% of the shares of the target company are held by U.S. holders, (iii) the take-over bid is subject to and not except from the Canadian take-over bid requirements, and (iv) the Canadian take-over bid documentation is disseminated to U.S. holders in compliance with Canadian procedures.

This is only a summary of the take-over bid rules that may apply. These are very technical in nature and need to be assessed carefully in the case of each going private transaction that is intended to proceed by take-over bid.

## Plan of Arrangement

A further technique for going private is pursuant to a statutory plan of arrangement. Through the plan of arrangement a company can pursue a broad range of fundamental changes under a single transaction. There are however a couple of important conditions. Firstly, a target company proposing to go private by plan of arrangement must obtain court approval to proceed. Secondly, as part of that court approval,

<sup>14</sup> National Instrument 71-101 – The Multijurisdictional Disclosure System.

the company must be able to demonstrate that it would not be practical to effect the fundamental change under any other provision of the applicable business corporation statute.

The process for conducting a going private plan of arrangement is not dissimilar from the amalgamation scenario with the exception of the necessary court approval.

- (i) Subsequent to negotiating support and lock-up agreements with the bidder, the target company will apply to the applicable court for an interim order. This interim order will specify the procedure by which the target company will proceed in obtaining shareholder approval, including the manner of calling, holding and conducting votes at a shareholders meeting.
- (ii) The target company will then mail its proxy circular and other meeting materials and hold a shareholder meeting.
- (iii) Upon obtaining an affirmative vote of shareholders, usually, two-thirds of the shares which are voted in person or by proxy, the target company will return to court for a final fairness hearing on the plan of arrangement transaction at which the court will consider the overall fairness of the plan of arrangement.
- (iv) Upon receipt of a final order of the court the target company can file articles of arrangement giving effect to the plan of arrangement.

Plans of arrangement are generally used in transactions that requires steps that go beyond the mere acquisition of the target company shares, such as arrangements with debentureholders, or where bids or amalgamations do not work well because of jurisdictional issues.

If there are U.S. resident shareholders of the target company or there is some other connection to the United States which would otherwise require registration of securities in the United States as part of the transaction, the target company may be able to avail itself of Section 3(a)(10) of the *United States Securities Act of 1933*. This provision provides an exemption from the registration requirements under such legislation in respect of certain court-approved transactions which generally includes a plan of arrangement. If this exemption is available, the bidder and the target company can avoid the need to file and clear a registration statement with the Securities and Exchange Commission which could potentially result in significant cost savings. To take advantage of this exemption, in addition to approving the fairness of the plan of arrangement, the court will have to actually approve the terms and conditions of the transaction.

## Formal Valuations

A formal valuation is a report prepared by a qualified and independent valuator that sets out an opinion as to the value or range of values of securities based on recognized valuation techniques. A formal

valuation will generally be required in the context of a going private takeover bid where the bidder is an insider or person acting jointly or in concert with an insider of the target company (or a person who was an insider of the target company within 12 months preceding the commencement of the bid). Similarly, a formal valuation will be required in respect of a going private transaction commenced by way of amalgamation, plan of arrangement or other business combination if a related party to the target company would, as a result of the transaction, directly or indirectly, acquire the target company, its business or combined with it either alone or with one or more persons acting jointly or in concert with the related party. The theory is that if insiders are on the acquiror's side and are involved in pricing the transaction, shareholders should have the benefit of an independent valuation.

There are a number of exemptions from the formal valuation requirements which may be applicable in a going private transaction. The following are some exemptions that may be available:

- (i) If the bidder has previously negotiated an arms length agreement with a significant shareholder at a price that is at least equal in value and in the same form as the consideration to be paid on the going private transaction, the target company may be exempt from the formal valuation requirements provided certain other conditions are met.
- (ii) A bidder will be exempt from the formal valuation requirements in the event the going private transaction is commenced at a time when there is already one or more publicly announced bids or proposed transactions in respect of the target company.
- (iii) If the target company's shares are not listed on a senior exchange (for example, the TSX Venture Exchange is not a senior exchange) the going private transaction will also be exempt from the formal valuation requirements.

Interested parties may also make an application to the Director, Take-over Bids with the OSC for discretionary relief.

In a take-over bid an independent committee of the target company must retain the valuator and supervise the preparation of the valuation. In a business combination the board of directors or an independent committee of the target company will retain the valuator and provide the supervisory rule. Rule 61-501 also stipulates requirements as to the qualification and independence of the valuator as well as the subject matter and the manner in which the valuation is to be prepared.

The takeover bid circular or proxy circular, as applicable, must satisfy certain disclosure requirements regarding the valuation. This includes incorporating a summary of the valuation or a full copy of it in the circular. The target company will also have to disclose every prior independent valuation.

## **Collateral Benefits**

A bidder may not enter into a collateral agreement with a shareholder of the target company or a related party that has the effect of offering greater consideration for that person's shares than for any other shares to be acquired pursuant to the going private transaction or otherwise provide a collateral benefit to such person. The new amended Rule 61-501 including the definition of "collateral benefit" which, although it is intended to reduce uncertainty, is still very broad in scope. Collateral benefits can include many arrangements that might be entered into as part of a going private transaction such as employment agreements, rights of first refusal and other agreements of a commercial nature. There are, however, some limited exceptions for benefits received by related parties as a consequence of a going private transaction, such as "golden parachute" arrangements with management of the target company.

In the context of a business combination the main implication of "collateral benefit" is that votes cast by a shareholder who obtains a collateral benefit will not counted on as part of the minority in determining whether approval has been obtained from a "majority of the minority" as discussed below.

For most going private transactions where the investors want to retain and motivate existing or new management to be brought in as part of the transaction, it will be necessary to carefully consider whether arrangements with management can fit within the enumerated collateral benefit exceptions. If an agreement is essential to the going private transaction but does not fall within one of the exceptions the bidder may consider applying to the Ontario Securities Commission for clarification or discretionary relief.

## **Majority of the Minority**

In addition to obtaining two-thirds approval of holders of each class of shares in the target company as required by applicable corporate law, Rule 61-501 requires that any amalgamation, arrangement or other business combination (other than in circumstances which do not involve related parties) must also be approved by a majority of the minority shareholders present in person or by proxy at the applicable meeting. This applies in respect of each particular class of shares voting at the meeting. The minority is determined by excluding any shares of the applicable class held by the target company, any related party to the target company, the bidder and any joint actors (with limited exceptions).

The way this works can be best explained by example. In a recent going private transaction completed by CARA Operations Limited a significant portion of the shares were held by related parties. As a result, certain institutional investors held a large enough portion of the minority such that the bidders proposing the going private transaction ultimately had to increase the offer to the public shareholders in order to get their support for the going private transaction. This type of situation not only increases the cost of the going private transaction but can delay completion of the transaction. See the timetable above.

The requirement to obtain approval by a majority of the minority is modified for a second stage amalgamation transactions which is preceded by a takeover bid provided (i) certain disclosure is made in

the takeover bid circular, and (ii) the bidder and the target company follow certain procedures following completion of the bid. In such circumstances shares acquired by the bidder as part of the takeover bid can be voted as part of the “minority” in a second stage transaction.

## **Dissent and Appraisal Rights**

As described above, certain fundamental changes to a target company trigger dissent rights under corporate law. Dissent rights allow any shareholder to dissent from the transaction and require the target company to buy its shares for cash at fair value. The events that give rise to dissent rights, also commonly known as the appraisal remedy, include amalgamation, plan of arrangement, sale of all or substantially all the corporate property, and varying share provisions by either changing share issue or transfer provisions or adversely affecting the rights of one or more classes of shares.

The Alberta Superior Court case of *Jepson v. Canadian Salt Co. Ltd.*<sup>15</sup> provides an example of dissent rights being triggered following an amalgamation proposal. The plaintiffs objected to an offer by the corporation which owned 80% of the shares of Canadian Salt to purchase their shares, after which the corporation intended to amalgamate with Canadian Salt. The plaintiffs sent several letters to Canadian Salt objecting to the price offered, but failed to meet the rigid procedure expected of dissenting shareholders under the CBCA. Canadian Salt proceeded with the amalgamation and the plaintiffs successfully sued for the fair market value of their shares. Even though the dissenters had not strictly complied with the requirements of the CBCA, the Court held that the law will be particularly concerned over the rights of the dissenters. Accordingly, the rigid dissent right procedures may not be construed against the interests of the dissenting shareholders.

Generally, any going private transactions of the nature described in this discussion (other than a takeover bid completed without a second stage amalgamation) will trigger dissent rights.

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<sup>15</sup> [1974] 4 W.W.R. 35, 99 D.L.R. (3d) 513 (Alta. S.C.)

## Corporate Governance

### Special Committees

In negotiating a going private transaction involving a related party (which will be the case in most instances if management or others related to the target company are to remain involved) it is good practice to establish a special committee of independent directors to safeguard against any real or potential conflict of interest or information advantage or other situation that may be perceived to be unfair. While Rule 61-501 only requires a special committee in certain circumstances such as retaining the valuator and supervising a valuation, the OSC is of the view that target companies should establish special committees in instances involving going private transactions.<sup>16</sup>

The special committee should consist of only directors who are independent from any related party to the transaction. While it might invite the attendance of non-independent board members and others with specified knowledge may be invited to attend from time to time, non-independent persons should not be present or participate in parts of meetings of the committee when decisions are to be made. A special committee will typically review any offer received from bidders and consider and make recommendations in the context of maximizing shareholder value. Generally, the mandate of the special committee does not include entering into a definitive agreement to give effect to a going private transaction. This is the responsibility of the broader board of directors. Rather, the special committee's role is to supervise the process of considering alternatives and making recommendations to the full board of directors.

It is important that the deliberations of the special committee be documented in such detail so that the target company will be in a position to include the necessary disclosure in its directors' circular or management proxy circular, as applicable. It is generally considered best practice to not have the chief executive officer of the target company as a member of the special committee. He or she is usually not independent and in any case will be actively engaged in other activities related to the going private transaction.

### The Role of Directors

In considering a going private transaction each director must keep in mind his or her duties to act honestly and in good faith with a view to the best interests of the target company and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The directors of the target company will need to assess whether the going private transaction is desirable or fair and in the best interests of shareholders taken as a whole. In making this determination the directors should be assessing all of the material factors which they consider relevant. This will involve the considerations and conclusions reached by any special committee as well as any analysis provided by third parties engaged to assist the directors and the special committee in their deliberations such as a

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<sup>16</sup> OSC Companion Policy 61-501, s. 7.1.

fairness opinion provided by an investment banking advisor and any valuation. Directors are entitled to, and should, rely upon the advice of experts such as financial advisors.

The directors of the target company are not legally required to consider all possible alternatives but rather the directors must consider whether the transaction or transactions under consideration are in the best interest of shareholders as a whole.<sup>17</sup> Unlike in the U.S., in Ontario at least, there is no requirement that a target company be sold by way of an auction.<sup>18</sup>

When a board of directors or special committee, as applicable, reaches a decision on a going private transaction, courts will generally respect its business judgment and not second guess its decision which, even with the benefit of hindsight, might not appear to be the best decision. A caveat to this is that directors in making their decision should do so after having carefully considered the advantages and disadvantages of the transaction and any available alternatives.

## **Documenting a Going Private Transaction**

### **Confidentiality Agreements**

As a condition to getting access to any due diligence materials of the target company it is common practice for the bidder and target company to enter into a confidentiality agreement. The bidder will typically covenant not to disclose any confidential information made available to it and its advisors through the due diligence process. A confidentiality agreement will also provide that the bidder will not use the information obtained for any purpose other than in respect of the going private transaction. Depending on the nature of the negotiation and the transaction, the target company's board will likely want to include a "standstill" provision in the confidentiality agreement which will restrict the bidder's ability to acquire shares of the target company or otherwise take action not approved by the board of directors of the target company.

If the proposed going private transaction is contemplated as part of an auction of the target company other provisions may be included in the confidentiality agreement, or ancillary documents may add additional rules, that the bidder and its advisors will have to comply with as a condition to getting access to the bidding process. These may include providing limitations on access to the target company's data room and its management and on obtaining copies of applicable documentation unless certain bid conditions are met.

### **Lock-up Agreements**

As a condition of proceeding with a going private transaction and depending upon whether the bidder is itself a controlling shareholder already a bidder will often negotiate lock-up agreements with the large

<sup>17</sup> Re Brant Investments Ltd. et al. and KeepRite Inc. et al. (1997) 60 O.R.(2d)737(Ont. H.C.J.).

<sup>18</sup> Maple Leaf Foods Inc. et al. v. Schneider Corporation et al. (1998) 42 O.R. (3d) 177 (Ont. C.A.)

shareholders, significant shareholders which may not have a controlling interest, as well as possibly directors and officers who hold shares in the target company. The lock-up may be a “soft lock-up” where a shareholder agrees to tender into the take-over bid or vote his or her shares in the favour of the going private transaction but reserves the right to withdraw if a higher competing bid or transaction comes to light or may be a “hard lock-up” where the shareholder irrevocably agrees to tender shares or vote in favour of the applicable transaction. The terms that face a particular lock-up will depend upon the nature of the negotiations and may range anywhere between a soft and hard lock-up. In Canada it is not uncommon for public companies to have one or more controlling shareholders. Large institutional shareholders will often agree to a soft lock-up but will typically not agree to a hard lock-up.

A bidder should also keep in mind that a lock-up agreement or any other agreement for that matter must not provide the shareholder with a collateral benefit as described above. The bidder should also be aware that it may be necessary to disclose the lock-up agreements and their material terms in a take-over bid circular or management proxy circular.

In *Re Sepp's Gourmet Foods Ltd.*<sup>19</sup>, the British Columbia Court of Appeal had concluded that a locked-up securityholder was disqualified from voting as part of the minority in determining whether a majority of the minority had been obtained. The recent amendments to OSC Rule 61-501 clarify that a lock-up agreement does not, in and of itself, constitute a locked-up shareholder as acting jointly or in concert with the bidder. This should eliminate the uncertainty raised by the *Re Sepp's* decision.

## Support Agreements

It is common practice as part of a negotiated going private transaction for the target company and the bidder to enter into a support agreement or pre-merger agreement. The nature of the agreement will depend upon the technique used to take the target company private. For example, in a plan of arrangement the support agreement will include covenants of the target company and the bidder to take the necessary actions to obtain interim and final court approval, prepare mail and file the management proxy circular, seek discretionary relief from regulators and take such other actions as may be required.

The support agreement will also include detailed representations and warranties in respect of the target company's business. The support agreement will also likely describe the obligation of the target company's board of directors to recommend acceptance of the offer and the circumstances under which the board may terminate the agreement upon receiving a superior offer. This will often be tied to a break fee or other means of deal certainty that the bidder may desire. The target company will want to leave open the possibility for a higher bid if there has been no auction for the target company. In this circumstance it will want a lower break fee. The bidder will, of course, want a higher break fee which typically may range as high as 4% or 5% of the transaction value.

As part of their lock-up agreements, shareholders may be asked to indemnify the bidder for breach of representations, warranties and covenants of the bidder. The support agreement will also set out

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<sup>19</sup> (2002), 211 D.L.R. (4<sup>th</sup>) 542 (B.C.C.A.)

conditions that have to be met before the bidder is required to complete the transactions giving effect to the going private transaction. Conditions may include no material adverse change to the business, a maximum number of dissenting shareholders, necessary shareholder approval and obtaining all applicable regulatory approvals and discretionary relief in order to give effect to the transaction. The specifics of the support agreement will depend upon the nature of the negotiations among the parties.

## Other Regulatory Considerations

### Competition Act

Depending on the size of a going private transaction, the bidder and the target company may be required to make pre-merger notification under the *Competition Act* (Canada)<sup>20</sup>. This generally will be required where the target is not already a subsidiary of the bidder, the combined assets in Canada or combined gross revenues from sales in, from and into Canada of the bidder and the target company together with affiliates exceed CDN\$400 million and the assets or revenues of the target company's business in and from Canada exceed CDN\$50 million.

The Competition Bureau will likely challenge any transaction which will have the effect of substantially lessening competition in Canada. Unless the going private transaction involves an investment by a strategic investor in the same or similar industry to the target company, it would appear unlikely that there will be any substantive issues in most going private transactions. Regardless, the pre-merger notification is mandatory if the relevant thresholds are exceeded.

In addition to or instead of making a notification, the bidder in a going private transaction may apply to the Competition Bureau for an advance ruling certificate for a transaction that does not give rise to substantive competition issues. This is discretionary but if issued provides the bidder with the comfort that the Competition Bureau will not challenge the going private transaction for three years following completion.

### Investment Canada Act

Where a "non-Canadian" as defined under the *Investment Canada Act*<sup>21</sup> proposes to acquire control of a Canadian business and the gross book value of the assets of the target company exceeds a certain threshold (\$237 million at the present time for investors or vendors from a World Trade Organization ("WTO") member country),<sup>22</sup> approval by the relevant Minister will be necessary as a condition of closing the going private transaction. The Minister will consider whether or not the proposed

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<sup>20</sup> R.S., 1985, C.C-34, as amended.

<sup>21</sup> R.S., 1985, C.28 (1<sup>st</sup> Supp.).

<sup>22</sup> For non-WTO countries the threshold is CDN\$5 million. The lower threshold also applies to WTO investors if the target company is in certain enumerated industries such as transportation, book publishing, film, televisions or other cultural industries or financial services.

acquisition is likely to be of “net benefit to Canada” and may negotiate certain undertakings with the bidders as to its business plans, including employment and expenditures in Canada. Practically, unless the target company is involved in a culturally sensitive area, such as book publishing, broadcasting, Investment Canada Act approval will be forthcoming.

### Other Restrictions on Foreign Investment

There are other statutory restrictions on foreign investment in certain industries within Canada. These include areas such as banking, insurance, financial services, transportation, telecommunications and broadcasting. Generally, these restrictions do not prohibit investment but require that control be maintained in Canada. Applicable statutory restrictions either limit the number of voting securities that can be held by non-Canadian and/or require that the applicable target company be able to demonstrate that “control in fact” is not in the hands of one or more non-Canadians.

### Conclusion

Given the significant capital requirements, going private transactions are well suited to private equity investors. With the current economic and regulatory environment, it is reasonable to expect we will see an increase in the number of companies going private in Canada in the near future. Private equity investors and their advisors should however be mindful of the significant time and cost associated with completing these transactions and should also be aware of the relatively complex regulatory framework.

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