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LAW 343 | Advanced Corporate  
Transactions

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## INTRODUCTION

### CAPITAL

- ❖ Meaning of “Capital”:
  - Generally: Money or the right to receive money
  - Specifically: the assets used by a business in its business
  - Acquired through capital raising
  - Instruments issued in capital raising take a multitude of forms
    - Debt: A promise to pay a certain amount on a certain date (eg promissory note)
    - Equity: Ownership interest. A right to receive an undetermined amount at an undetermined date should any amount be paid (eg common shares)

### VEHICLE

- ❖ Various flavours of vehicles for a venture:
  - Sole proprietorship, general partnership, limited partnership, trust, corporation, limited liability company, unlimited liability company
- ❖ Most well developed structure: corporation
  - Not necessarily best for all uses, but people understand how it works and it has well developed protections for participants. That makes it easier to convince people to participate, which makes it easier to raise capital.
  - Offers the best form of liability protection

### EQUITY

- ❖ Common shares in a company are the fundamental building blocks
- ❖ A bundle of rights
- ❖ Most important two
  - Right to elect board of directors (control of strategic direction of company)
  - Right to participate rateably in distributions and upon liquidation (upside!)
- ❖ Two types: common shares, preferred shares

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### ATTRIBUTES

- ❖ Shares have different attributes – bundle of rights
- ❖ **Three critical areas must be covered:**
  - Voting (elect the board)
  - Participation (dividends)
  - Assets on liquidation
- ❖ **Par value vs. non-par value [look into]\*\***

- BC Company vs. CBCA Company
- ❖ Not all Classes have all three rights
  - Voting scrip
  - Non-voting participating scrip
- ❖ Other creative rights – within statutory framework
- ❖ Common vs. Preferred
- ❖ Name not determinative

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## CREATIVE RIGHTS

### ❖ **Considerations**

- Conversion Rights
  - Convert into what?
    - Common to preferred, vice-versa
  - Conversion rates
    - Can affect ownership percentage
  - Anti-dilution
    - If you have a controlling vote, you want to maintain that
  - Changes to attributes
  - Tax effect (deemed disposition)
- Redemption/Retraction (think of as put/call actions) (opposite meanings in the US)
  - Redemption price
    - Set dollar amount
    - Formula
    - Value of Property
  - Failure to Redeem – special rights (voting, extra-dividends, conversion)
  - Different triggers for engagement of redemption/retraction rights
    - Notice period
    - Standstill period, etc.
      - ◆ Period of time during which you cannot retract your shares.
- Voting
  - Selective
  - Class
  - Veto
- Dividends
  - Sprinkling; Discretionary; Preferential; Pari Passu; Fixed; Cumulative; None (voting scrip)
- Priority on Liquidations
  - Straight ranking
  - Mixed ranking



- Amounts paid-up first, then ratable sharing of assets, other thresholds
- No entitlement

## DEBT

- ❖ Debt has three principal features:
  - Principal amount
  - Interest rate
  - Maturity
- ❖ Most important feature: certainty of return.
  - Debt ranks first on the priority chain
- ❖ Can have a number of features to enhance certainty of return
  - collateral,
  - covenants,
  - seniority
- ❖ Constrained upside (return limited to principal + interest)

## CONTROL VS. CERTAINTY OF RETURN

- ❖ When determining how to capitalise a company the founders and funding sources need to make certain decisions
  - How much control of the company do they want?
  - How much risk are they willing to take that their investment may be lost?
- ❖ At a basic level, the instruments used for capitalization trade control for certainty of return
- ❖ **Control** **Certainty**  
*Common Shares > Preferred Shares > Hybrids > Junior Debt > Senior Debt*

## HYBRID SECURITIES

- ❖ Some investors want a little of both worlds
- ❖ Hybrid instruments include: Convertible preferred shares, convertible notes
- ❖ A hybrid is essentially a warrant “stapled” to the underlying security, and the currency to exercise the warrant is the underlying security itself
- ❖ Allows investors to start with enhanced certainty of return but opt into control and increased upside

## DEBT CONSIDERATIONS

- ❖ Convertible Debt vs. Straight Debt
- ❖ Restrictive Covenants – Effect on Company
  - Debt/Equity Ratios

- Loan to Value Ratios
- Performance Ratios
- Liquidity Ratios
- ❖ Monitoring Obligations
- ❖ Security /Encumbrances – Effect on Company
- ❖ Personal Guarantees
- ❖ Effect on Balance Sheet

## EQUITY CONTROL

- ❖ The amount of control increases with the amount of voting shares held (by a person or a group)
- ❖ Key thresholds:
  - 5% can requisition meeting
  - 10% blocks compulsory acquisition
  - 33 $\frac{1}{3}$ %+1 blocks special resolution
  - 50%+1 passes ordinary resolution
  - 66 $\frac{2}{3}$ % passes special resolution
  - 90% allows compulsory acquisition

## RESOLUTIONS

- ❖ Ordinary resolutions
  - Most important – election of board of directors
  - Directors hire officers, set strategic direction
- ❖ Special resolutions
  - Allow fundamental restructuring
  - Allows forced sale of company or squeeze out through a plan of arrangement (aka cram down)
- ❖ Resolutions passed at meetings which are called by directors unless requisitioned
- ❖ Compulsory acquisition – allows simple squeeze out

## LEGAL, REGULATORY, ACCOUNTING

- ❖ Corporate Statute - framework
- ❖ Securities laws and filing exemptions (debt/equity)
- ❖ Tax Planning
  - For the Company
  - For the holder (debt/equity)
- ❖ Exit Strategies
  - For the company – cleansing

- For the holder (risk, liquidity)
- ❖ Future Financing Strategies
  - Balance sheet – financial health

## CORPORATE FORMATION AND SEED CAPITAL FINANCING

### CHOOSING A LEGAL FORUM

- ❖ Not every idea should form a business – not worth pursuing in a corporate form
- ❖ Idea for business must be evaluated in light of:
  - Competitive Power
  - Access to Resources
  - Lifecycle of idea
    - Other company can copy and beat you in 6 months?
- ❖ After evaluation need to choose best path to exploitation of idea:
  - Incorporation?
  - Licensing or sale?

### COMPETITIVE POWER

- ❖ Investors are looking for abnormal profits (50% not 20%)
- ❖ Reduction of profit opportunities can come from:
  - Other participants in the industry
    - Selling the same type of product
  - Other consumers of necessary inputs
    - Buying the same materials
  - Suppliers of required materials or services
    - If they're vertically integrated
  - Customers where the product is used by a limited set of persons
    - Selling a product for the navy? How many are there?
    - Public company? Competitors can see what your pricing is (revenue in chunks)
- ❖ If profit opportunities are constrained, consider licensing or sale of idea

### ACCESS TO RESOURCES

- ❖ Start-ups require access to financial and human resources
- ❖ Start-up financing can come from:
  - Love money
    - Parents, based on you, not the idea
  - Angel or venture capital
  - Sweat equity
- ❖ Important to assess the venture's capital needs
  - Product development time? Time to revenue? Gross margin?
- ❖ Human resources – is there someone with experience building and running a plant?  
Raising and spending \$?
- ❖ If sources of capital and human resources are not identifiable, consider licensing or sale

### LIFECYCLE OF IDEA

- ❖ Ideas have an expiry date

- Is there a short time to exploit idea? Established companies are more likely to be able to profit
  - Investors don't always want to wait forever for it to be established
- Is there a complex infrastructure that needs to be put in place? Established companies that can use existing infrastructure have an advantage
- Will the idea support sustained and rapid growth?
- How likely is it that the idea will get transferred to a competitor?
  - Idea that you can't patent? Unlikely to be able to protect if someone goes to competitor

## INCORPORATION VS. LICENSING

- ❖ If competitive power, access to resources and the nature of the idea all indicate a start-up is the most viable course of action, discuss incorporation with the client.
- ❖ Licensing or sale of the idea are the alternatives
- ❖ Licensing is a grant of the rights to the idea to another person, sometimes limited in time and geography, in exchange for payment, which may be upfront or over time
- ❖ Some work will need to be done to ensure the idea is licensable/saleable (the idea has to be implementable and you have to have something to transfer (a patent? A process protected as a trade secret?))

## STRUCTURING THE ENTERPRISE

- ❖ Where start-up is the preferred route:
  - Growth business vs. normal start-up?
    - "Normal" company? Sole proprietorship or partnership are most common forms
      - Significant tax advantage over incorporation at early stage: losses can be applied against any business income.
    - Growth company? Incorporation is usually done early"
      - Allows venture investors to invest with limited liability
      - Avoids employees having joint and several liability for the venture's obligations
      - Almost always corporations

## TAX CONSIDERATIONS

- ❖ Flow-through vehicles
  - Partnerships, limited partnership and limited liability corporations are all transparent for tax purposes
- ❖ Growth companies start out as loss-making
  - Established companies can immediately use the losses against other revenue
  - Flow-through entities can flow the losses to their partners/members, who can use them to shelter other revenue
  - Newly incorporated growth companies have losses, but rarely have revenue to shelter
- ❖ On its face, flow-through entities seem advantageous

## CONSIDERATIONS OF POTENTIAL INVESTORS

- ❖ The types of venture investor *theoretically* influences choice of corporate structure:
  - LS VCCs – flow-through entities; investors receive federal tax credits
  - Pension Funds – exempt from taxation
  - Government – usually exempt from taxation
  - Corporations – losses reduce reportable earnings, so they typically avoid flow-through
  - Individuals – private equity funds are usually structure as flow-through vehicles, however individual direct investors often avoid them because difficult to make them “qualified investments” for RRSPs, otherwise they would be preferred.
- ❖ But in practice, most ventures use corporations

## COST CONSIDERATIONS

- ❖ Cost of incorporation: off-the-shelf is below \$1000
- ❖ Cost of formation of a flow-through vehicle: each is custom designed and can be many multiples more expensive
- ❖ Limited case law on duties of general partners to limited partners, so these must be drafted and added to the LP agreement

## BATES V. BROWNSTONES EAST

- ❖ General partner refused to give information on why a cash call had been made to limited partners. Unlike in corporations the limited partners had:
  - No clear right to specific information
  - No clear mechanism for enforcing the right to obtain a list of other LPs so they could contact enough to requisition a meeting to remove the GP
  - N straightforward ability to ask court to remove the GP (query whether use of Trustee Act would work in BC?)
- ❖ The lack of jurisprudence and clear statutory dispute settlement mechanism makes LPs inherently more “complex” than corporations

## FUTURE STRUCTURING CONSIDERATIONS

- ❖ Employee Share Option Plans (ESOPs)
  - Used to incentivise employees
  - Typically found in corporations, but can be duplicated in a partnership or synthesized through participation rights
  - Employees expect options and are comfortable with them: causing discomfort is not good when trying to build an incentive program
  - Option is the right to acquire a share or security at a fixed price for a certain period of time
- ❖ IPO
  - Difficult to list LP interests (though not impossible). Market is distrustful of them as there is little guidance on how they work in contentious situations.

## CONTROL

- ❖ S. 64 of the BC Partnership Act
  - “a limited partner is not liable as a general partner unless he or she takes part in the management of the business”
- ❖ In reality, GPs are usually shell corporations and the LPs are the only persons with actual capital at risk
- ❖ When business is bad, LPs don’t want liability but if they take actions to try to protect investment they run the risk of violating s. 64
- ❖ *Haughton Graphic v. Zivot*: no need for specific reliance by creditors, if LPs are officers of GP, they are taking part in the business (Ont. Case, Alta. partnership)
- ❖ *Nordile v. Breckenridge*: found that acting as officers of the GP was not sufficient to give LPs liability, however: the GP in Nordile was a real business, most GPs of limited partnerships are shells; the agreed statement of facts in Nordile was a mistake by the plaintiff; the BCCA endorsed *Haughton*.

## GOVERNMENT PROGRAMS

- ❖ Tax incentives privilege corporations:
  - Flow-through shares in mining and oil and gas exploration
    - Allow 100% of qualifying exploration expenses to be “flowed through” to shareholders and 30% of development expenses; the company has no taxable profit, so it can’t use the expense
  - SR&ED credits (scientific research and ...)
    - Refundable tax credits for 20 – 35% of qualifying R&D expenditures; refundable so if they exceed your taxes you get paid cash
    - Only available to CCPCs
    - Can’t be passed on to a limited partner

## ORGANIZING A GROWTH COMPANY

- ❖ **Jurisdiction of incorporation**
  - Little reason to “jurisdiction shop” in Canada
    - Though BC has no director residency requirement
  - US is different, with Delaware having most incorporations
    - Not necessarily cheaper, but Delaware has the most well understood corporate laws and investors like reducing uncertainties
- ❖ **Classes of Shares**
  - Typically two, common shares and blank cheque preferred shares
- ❖ **Restriction on transfer**
  - To fit into the “private company exemption” under NI 45-106 from the prospectus requirements of securities laws, private companies need a restriction on transfer in the constating documents or in a unanimous shareholders agreement
- ❖ Number of directors – provide for a broad minimum and maximum
- ❖ By-laws/articles

- Should be kept simple. Investors will require provisions, which entrench management (staggered boards etc.) to be stripped out.
- For tech companies, if employees are also shareholders, consider putting non-competition provisions in the by-laws/articles. When in an employment contract can be unenforceable if company is found to have violated the employment contract.  
*Towers Perrin v. Cantin*

## SEED CAPITAL

- ❖ Two main concerns
  - Reflect where founders believe control should reside
    - Each dilutive equity issuance will reduce the founders control
  - Make the company attractive to investors
    - Avoid unneeded complexity; make the benefits of investing clear

## DEBT

- ❖ Any obligation of the company
- ❖ Short-term debt
  - Accounting: Due in 12 months or under
  - Often in the form of trade credit (30-60 day payment terms with usually no enforced interest).
- ❖ Long-term debt
  - Accounting: due in more than 12 months
  - Notes, bonds or debentures
    - No real distinction other than in practice notes are short, bonds are secured and debentures are unsecured
- ❖ Conventional debt typically unavailable to growthcos
- ❖ **Four primary characteristics:**
  - An obligation to repay the amount initially invested
  - A legally enforceable rate of return (interest) that does not vary with the company's profit
  - Paid before equity on insolvency (which is why people argue about whether something is equity or debt)
  - Usually involves terms and conditions imposed by contract

## EQUITY

- ❖ Equity in law typically refers to an ownership interest in an incorporated company
- ❖ In finance, it refers to total assets less liabilities
- ❖ Different from debt:
  - Ranks behind debt on insolvency
  - Interest of equity holders are protected through statute, not contractual terms (deals with "agency problems")
    - Directors and officers are fiduciaries



- Voting rights are given to shareholders for election of directors and on fundamental changes (e.g. amalgamation, plan of arrangement, sale of all or substantially all of assets)

## CAPITAL STRUCTURE – DEBT OR EQUITY?

### ❖ Identity of investor

- An arms length, venture capital investor will insist that management are the last stakeholders who can exit their investment
- Foreign investors may prefer debt
  - 25% withholding tax imposed on dividends to non-residents
  - Debt is often exempt from withholding
  - Canadian tax is payable on sale of “taxable Canadian property”
  - Though GET TAX ADVICE – this stuff changes all the time.

### ❖ Exit strategy

- Debt investors have a different exit than equity as they have a guaranteed return
- If a company has significant debt, it is difficult to convince new investors to take equity (especially if the funds from the sale of equity will be used to pay debt)

### ❖ Tax treatment

- Issuer: interest is tax deductible, dividends are not
- Holder: equity gives rise to capital gains on its sale, interest is income. Income is 100% taxable, whereas capital gains are only 50% taxable.

### ❖ Dilution

- Debt is not dilutive as it does not involve a sale of part of the company
- However, venture debt typically has an equity kicker, eg., warrants or a convertibility feature, so it is only less dilutive, not non-dilutive

### ❖ Risk/reward

- Debtholders receive no reward for successfully taking risks in running the business. Debt covenants typically try to reduce the risks that can be taken.

## ALLOCATION OF CONTROL

### ❖ Two common mistakes:

- Giving too much control to someone who is not integral to the future development of the business
  - They do not have the context to make decisions but have a large say in the business; it leads to alienation of executives who are working harder for a smaller stake
- Giving equal control to all founders with only a nominal “president”
  - Consensus often impossible to achieve
  - Reality is someone is going to be forced into the position of leader

## FOUNDERS’ SHARES

### ❖ Pitfalls: Phantom Income

- if you incorporate on July 1 and give founders a miniscule amount, then bring in VC at \$2/share, CRA won't believe that shares before were worth 1/1000<sup>th</sup> of a dollar. Becomes a gift of \$1.99 at that point, taxable income.
- Founders' shares are usually issued for nominal consideration (i.e. \$0.00001 per share)
- If founders' shares are issued too close in time to shares issued to outside investors, then the CRA may view the difference in price to be a gain. (i.e. if the outside investor pays \$1 per share the day after a founder paid \$0.00001 a share, the CRA may require the founder to take 50% of \$0.99999 per share into income as a capital gain. Money you don't receive but have to pay taxes on is called "Phantom Income"

## SHAREHOLDERS' AGREEMENTS

### PURPOSE

- ❖ Shareholders Agreement – regulate the behaviour of shareholders
  - Allocate management control
    - Who can be directors (certain investors may get a nominee on the board)
    - Thresholds for decision making
    - Transfer of board powers from directors to others
  - Restrictions on transfers of shares
    - When a share can sell/buy
    - When a shareholder must sell/buy
    - Procedural rules
    - Deal terms
    - Careful not to hinder future equity financings

### UNANIMOUS SHAREHOLDERS AGREEMENT

- ❖ USA
  - Creature of Statute
  - Name not determinative
  - If statutory tests are met – additional protections apply to the USA
  - If statutory tests are not met – contractual agreement (without the statutory benefits)
  - Should always determine whether or not a SA is a USA before relying on the statutory provisions
  - **Always determine whether or not you meet the test before you rely on the provisions**

### USAS UNDER THE CBCA

- ❖ CBCA s. 146(1) tests
  - Otherwise lawful written agreement (basic contract principles)
    - Formation of contract, principles and elements of K to make it lawful
  - All of the shareholders of the corporation (may include non-shareholders)
  - Restrict (in whole or in part) powers of the directors to manage, or supervise the management of, the business and affairs of the corporation
- ❖ CBCA s. 146(2)
  - Allows a sole shareholder to do a USA
  - Declaration by holder of all the issued shares of a corporation qualifies
- ❖ CBCA s. 146(3)
  - Purchaser/transferee of shares is deemed to be a party to the USA
- ❖ CBCA s. 146(4)
  - If notice of USA isn't given as per s. 49(8), purchase/transferee can rescind within 30 days of becoming aware

- ❖ CBCA s. 49(8)
  - Restrictions on transfer (excluding s. 174 Contract on Shares), and USAs, are not effective against a transferee without actual knowledge unless noted conspicuously on the certificate
- ❖ CBCA s. 146(5)
  - Parties given the director's powers take on the rights and fiduciaries of directors in respect of those powers, and directors are so relieved
  - Double-edged sword – must act in the best interests of the corporation (instead of an investor's self-interest)
- ❖ CBCA s. 146(6)
  - USA cannot fetter shareholders' discretion when exercising directors' powers

#### CBCA S. 146

- ❖ **Unanimous shareholder agreement**
  - **146.** (1) An otherwise lawful written agreement among all the shareholders of a corporation, or among all the shareholders and one or more persons who are not shareholders, that restricts, in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation is valid.
- ❖ **Declaration by single shareholder**
  - (2) If a person who is the beneficial owner of all the issued shares of a corporation makes a written declaration that restricts in whole or in part the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation, the declaration is deemed to be a unanimous shareholder agreement.
- ❖ **Constructive party**
  - (3) A purchaser or transferee of shares subject to a unanimous shareholder agreement is deemed to be a party to the agreement.
- ❖ **When no notice given**
  - (4) If notice is not given to a purchaser or transferee of the existence of a unanimous shareholder agreement, in the manner referred to in subsection 49(8) or otherwise, the purchaser or transferee may, no later than 30 days after they become aware of the existence of the unanimous shareholder agreement, rescind the transaction by which they acquired the shares.
- ❖ **Rights of shareholder**
  - (5) To the extent that a unanimous shareholder agreement restricts the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation, parties to the unanimous shareholder agreement who are given that power to manage or supervise the management of the business and affairs of the corporation have all the rights, powers, duties and liabilities of a director of the corporation, whether they arise under this Act or otherwise, including any defences available to the directors, and the directors are relieved of their rights, powers, duties and liabilities, including their liabilities under section 119, to the same extent.
- ❖ **Discretion of shareholders**

- (6) Nothing in this section prevents shareholders from fettering their discretion when exercising the powers of directors under a unanimous shareholder agreement.

#### CBCA S. 49(8)

#### ❖ Restrictions

- **49 (8)** No restriction, charge, lien, hypothec, agreement or endorsement described in the following paragraphs is effective against a transferee of a security, issued by a corporation or by a body corporate before the body corporate was continued under this Act, who has no actual knowledge of the restriction, charge, lien, hypothec, agreement or endorsement unless it or a reference to it is noted conspicuously on the security certificate:
  - (a) a restriction on transfer other than a constraint under section 174;
  - (b) a charge, lien or hypothec in favour of the corporation;
  - (c) a unanimous shareholder agreement; or
  - (d) an endorsement under subsection 190(10).

#### DIRECTORS' POWERS BC BCA

- BCBCA has no USA concept
- Directors Powers may be restricted and transferred under the Articles
- BCBCA s. 137(1)
  - Subject to (1.1), company's articles and restrict and transfer, in whole or in part, directors' powers to manage or supervise the management of the business and affairs of the company.
- BCBCA s. 137(1.1)
  - To be effective must be in the Articles and expressly reference the intention to transfer powers to the proposed transferee
- BCBCA s. 137(2)
  - Transferee of the powers take on the rights and fiduciaries of directors in respect of those powers, and directors are so relieved
- BCBCA s. 137(3)
  - References in the Act to directors are deemed to be the transferee of the powers, to the extent of the transferred powers
- BCBCA s. 137(4)
  - Special resolution to change the transfer of powers contained in the Articles
- S. 137 not widely used – publicly available, doesn't apply to restrictions on transfers by the shareholder
- Heavy reliance on contractual Shareholders Agreements.
- Not tested by the courts.

#### BCBCA S. 137

#### ❖ Powers of directors may be transferred

- **137 (1)** Subject to subsection (1.1) but despite any other provision of this Act, the articles of a company may transfer, in whole or in part, the powers of the directors to manage or supervise the management of the business and affairs of the company to one or more other persons.
- (1.1) A provision of the articles transferring powers of the directors to manage or supervise the management of the business and affairs of the company is effective
  - (a) if the provision is included in the articles at the time of the company's recognition or if the company resolved, by special resolution, to add that provision to the articles, and
  - (b) if the provision clearly indicates, by express reference to this section or otherwise, the intention that the powers be transferred to the proposed transferee.
- (2) If the whole or any part of the powers of the directors is transferred in the manner contemplated by subsection (1),
  - (a) the persons to whom those powers are transferred have all the rights, powers, duties and liabilities of the directors of the company, whether arising under this Act or otherwise, in relation to and to the extent of the transfer, including any defences available to the directors, and
  - (b) the directors are relieved of their rights, powers, duties and liabilities to the same extent.
- (3) If and to the extent that the articles transfer to a person a right, power, duty or liability that is, under this Act, given to or imposed on a director or directors, the reference in this Act or the regulations to a director or directors in relation to that right, power, duty or liability is deemed to be a reference to the person.
- (4) A company may resolve to alter its articles, by special resolution, to alter a provision referred to in subsection (1.1).

#### NO FETTERING.

- ❖ Directors' powers cannot be fettered whether exercised by the directors under the Act (CBCA, BCBCA, etc.) or pursuant to a contractual Shareholders Agreement, or as shareholder r(or other person) as transferee of powers under a USA (CBCA) or Articles (BCBCA)
- ❖ Fiduciary must be free to decide
- ❖ Requiring higher thresholds under a USA or a Shareholders Agreement != fettering
- ❖ Stating how a decision must be made (e.g., voting for or against specified matters) = fettering.

#### PREPARING TO DRAFT A USA

- ❖ Who is the client?
  - Minority shareholder
  - Majority shareholder
  - Private equity, business partners, etc.
- ❖ Understand the company
  - Management roles
  - Business plan

- Funding the business
- Distributing profits
- Anticipated arrivals or departures
- Related companies or operations
- ❖ Careful not to hinder operations and growth to the point of being detrimental

## GOVERNANCE

- ❖ Board of Directors
  - Constitution
    - Rights of appointment – nominee on the Board vs. named individuals
    - Number of nominees for each shareholder or shareholder group
    - Loss of nominee rights
  - Meetings
    - Quorum first attempt to hold a meeting and reconvened meetings
    - Dealing with deadlock and casting votes
    - Matters requiring a vote and matters that require the approval of specific directors
    - Matters that require approval of shareholders and approval thresholds (2/3, majority, class approval)
    - Matters to be decided by shareholders instead of the directors (try to keep out of operations for growth companies)
  - Restrictions on Powers
    - Division of decisions between directors and shareholders
    - Be careful of veto power
  - Examples of matters decided by or approved by shareholders
    - Approval of budgets and business plans
    - Capital expenditures exceeding \$X in any fiscal period
    - Wage increases to founders and other non-arm's length persons, management bonuses above agreed thresholds
    - Entering into contracts with non-arm's length parties
    - Corporate borrowings beyond agreed thresholds (could be zero threshold) and granting security on the assets and undertaking of the company, granting guarantees or providing other forms of financial assistance
    - Repayment of loans to any person who is not arm's length or any affiliate
    - Creating or permitting subsidiaries or corporate affiliates
    - Business acquisitions or divestitures
    - Issuance of shares or other rights to acquire shares
    - Redemption or repurchase of shares by the company
    - Declaration or payment of dividends
    - Material change in, or termination or suspension of any material part of its existing business, Winding-up, dissolution
    - Fundamental corporate changes (amalgamation, continuation, reorganization or arrangement)
    - Life insurance paid by the company (key man insurance) appoint a managing director or create any committees of the board of directors of the Corporation;

- Qualifying Public Offering (allowing investors to include their shares in the offering)
- Creation of and changes to employee stock option plans
- Termination of key employees

## CAPITALIZATION

- ❖ Initial capital contribution of shareholders
- ❖ Funding through debt and/or equity?
- ❖ **Pre-emptive rights**
  - What is it?
    - Mechanism that allows shareholder to maintain proportionate equity interest in the company if the company issues additional shares
  - When and how to use it?
    - Access to funds while giving option on dilution to an existing shareholder
    - Control over admittance of new shareholders
    - Option to purchase all or some
    - Second round right to existing shareholders
    - Failure to subscribe = dilution
    - Assessment of smaller percentage of larger pie
- ❖ Shareholder obligations to secure or guarantee loans?
- ❖ Additional funding obligations
  - Circumstances
  - Maximum amount
  - Who gets called (*pro rata*?)
  - Notice
  - Default and consequences
- ❖ **Loans and Distributions**
  - Shareholders loans
    - Will there be shareholder loans?
    - What will the terms be (eg interest)
    - Repayment of loans (consent requirement)
  - Distributions
    - Can remain silent and leave to board discretion or, if money is available for regular distributions or parties wish to move funds out of company regularly, consider addressing
      - Appropriate distribution timing (monthly, quarterly, annually, etc.)
      - Amount available for distribution and solvency
      - Manner of distribution – dividend, return of capital, etc.

## CONFIDENTIALITY, NON-COMPETES, IP

- ❖ **Confidentiality**
  - USA will typically require shareholders and their representatives to keep certain information confidential



- Consider specific circumstances (size, nature of business, number of shareholders, relationship among shareholders, relationship of shareholder with company)
- Carve-outs and exceptions (available to public, required by law when selling shares, etc.)
- Investor exceptions to confidentiality obligations (e.g., potential purchasers of investors' interests)
- Typically, you will define what will be confidential and include carve-outs, tend to be information that is typically public (though excludes info that is only in public because of your breach), or when there is a court order, or to financial advisors, etc.
- ❖ **Non-Competes**
  - Preventing or limiting shareholders from competing with company while shareholders also for a period after they cease to be a shareholder
  - Restrictions that are too onerous can lead to issues of enforceability
  - Consider whether non-solicit provisions are also required
  - Typically applies to key shareholders with "inside" knowledge
- ❖ **Intellectual Property**
  - Nature of business may require specifically addressing IP particularly where a shareholder has brought specific IP to the company or might improve upon IP while at the company
  - Deal with ownership of IP (ownership stays with shareholder and is licensed to company or ownership resides with the company)
    - Could be: no soliciting people, but a general advertisement to the public is okay, or could be so restrictive that you can't work at competitors for a period of 2 years, etc.

## AMENDMENTS AND TERMINATION

- ❖ **Amendments**
  - Thresholds for amendments – typically an agreed percentage of outstanding shares must approve (eg, 2/3rds)
  - Investor class may have vetoes over certain amendments even where the threshold is otherwise met.
  - CBCA is silent, USA may set approval terms and percentages
- ❖ **Termination**
  - Specific date
  - Specified events
    - When one shareholder holds all the shares
    - On winding up or dissolution
    - On completion of an IPO
    - By written agreement

## SHARE TRANSFERS

- ❖ Usually contain a general restriction on transfers of shares
- ❖ Permitted and prohibited transfers (ledges vs. transfer to affiliates)
- ❖ Contemplate changes in shareholdings – triggering events

- Voluntary and involuntary departures (e.g., founders, key employees)
- Resignation or dismissal of employees
- Planned departure
- Cashing out
- Dispute resolution
- Unwanted shareholders
- Death/incapacity
- Insolvency

## SHARE TRANSFER MECHANISMS

### COMMON MECHANISMS

#### ❖ **Shotgun clause**

- One or more shareholders attempt to sell their shares, or acquire the shares of any other shareholder, in a forced buy-sell arrangement
- The “triggering” shareholder proposes a price at which that shareholder will sell their shares or purchase the shares of the other person
- The receiving shareholder merely decides whether to buy or sell at the stated price.
- When and how to use it?
  - Works best where the shareholders are equal in terms of importance to company, ability to finance, and willingness and ability to own and operate the business independently
  - In right circumstances will help avoid deadlock and facilitate dispute resolution
  - Problems may arise if shareholders are unequal (e.g. financial vulnerability, key employee) at the time of triggering
  - Becomes more complex if there are more than two shareholders
  - Consider minimum thresholds and basic terms
  - Ability to add conditions to the trigger complicates matters
  - Consider effect on other provisions (e.g., officer/employment entitlements shouldn't survive shotgun exits)
    - Example: two guys, in business forever, trust, etc., other guy comes in and

#### ❖ **Right of first refusal**

- Two types: “hard” RFR and “soft” RFR
- Hard RFR
  - Shareholders must obtain and wish to accept a bona fide offer from an arm's length purchaser
  - Other shareholders must be given option to acquire selling shareholders shares for same price and on same terms
  - Requires a “stalking horse” offer – impairs liquidity of shares (reluctance of third parties, cost and inconvenience of negotiating a bona fide offer that may be usurped)
  - Will know the identity of the potential new shareholder if RFR declined
  - Price test by market – better value assessment
- Soft RFR

- Selling shareholder must first offer to sell to other shareholders on desired terms
  - If offer not accepted shareholder can sell to third party on terms no more favourable than those offered to the shareholders (otherwise, need to go back to other shareholders with improved offer first)
  - No control on who will buy if RFR declined, just the terms at which they buy (in a growth company, “who” shouldn’t matter unless it’s a competitor)
  - May result in shareholders paying higher than market price – price not tested in the market
- ❖ **Piggy-back (tag-along) rights**
- What is it?
    - If one or more of the shareholders is selling shares to a third party, the sale can not proceed unless the third party also makes an offer to purchase the shares of other shareholders on the same terms
  - When and how to use it?
    - Usually only applies to majority shareholders’ sale of shares (so that the minority doesn’t get left behind)
    - Majority could be by threshold, or by investor
    - Often used in conjunction with drag-along right
    - Interplay with right of first refusal to be considered
    - Can be structure to contemplate the sale of each shareholder’s respective shares or, alternatively, allow other shareholders to tag along on a pro rata basis consistent with the percentage of shares of the selling shareholder being sold.
- ❖ **Drag-along rights**
- What is it?
    - Right of a shareholder to compel other shareholders to sell their shares to a third party to accommodate sale of whole company
  - When and how to use it?
    - Usually applies to benefit a majority shareholder (e.g., majority can drag the minority, but minority cannot drag the majority) – enhances liquidity option
    - May cause significant risks to minority shareholders, compels sale, timing or deal may be unfavourable, tax consequences on sale of share (consider matching bid provision)
    - May subject drag-along right to prior compliance with RFR where equity interest by the shareholder being compelled to sell is material
    - Consider use of power of attorney or escrow of signed transfer documents
- ❖ **Put and Call Options**
- Put Option
    - Right of shareholder to require company or other shareholders to purchase their shares (e.g., put the shares to someone)
  - Call Option
    - Right of company or other shareholders to purchase shares from a shareholder (e.g., call the shares from someone)
    - Audited financial statements?
  - When and how to use it?

- Used in connection with a specified event or the departure of a shareholder from the company, for example:
  - Resignation or dismissal of employee-shareholder
  - Bankruptcy of shareholder
  - Inability to carry out obligations under SA, USA or default
  - Temporary or permanent incapacity or death
- Create mechanisms for exercise, payment, valuation
- For company repurchases – solvency requirements of CBCA/BCBCA
  - Used by company where the shares do not have redemption rights
- Can cause financial strain (buyer on a put option has to come up with the purchase price, typically in 30 days)
- Offer liquidity where there is none
- Payment can be staggered over time if price exceeds agreed thresholds

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## CONSIDERATIONS

- ❖ Role of shareholders (passive vs. active, numerical or financial superiority)
- ❖ Financing
- ❖ Deposits
- ❖ Multiple shareholders
- ❖ Financial Capacity
- ❖ Guarantees, loans
- ❖ Multiple buy-sell provisions
- ❖ Determining GMV of shares for sale
- ❖ Premiums and discounts
- ❖ Procedural requirements and timing mechanisms

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## FAIR MARKET VALUE (FMV)

- ❖ On shotgun, no issue, just receiving end.
- ❖ Ways to determine FMV:
  - If listed, what it's at
  - Private company?
    - Get a chartered business evaluator to give an evaluation – similar to audited financial evaluation
    - Do you do it on a breakup valuation?
    - As an ongoing concern?
    - Earnings before .... EBITDA?
  - When you get an evaluation done, typically in a range, \$5-\$10 million?
    - Provision may say the mid-point in a range.
  - How do you pick the evaluator?
  - Sometimes just a formula.
- ❖ Anything relative to the sale that is not addressed is a potential dispute area

## CORPORATE GOVERNANCE

### CORPORATE ACTORS

- ❖ Various corporate actors have opportunities for malfeasance
  - Shareholders: Can vote shares to approve transactions that treat other shareholders harshly
  - Directors: Can set policies (dividends for example) to divert benefits from one group to another (between shareholders, or between shareholders and employees)
  - Officers: Can divert corporate assets to their own benefit

### DUTIES & REMEDIES

- ❖ To combat these opportunities for abuse:
  - Shareholders have access to:
    - Oppression remedy
    - Winding up order
    - Derivative actions
    - Dissent rights
    - Court ordered inspection
  - Directors and officers have statutory and common law duties and obligations

### OPPRESSION AND WINDING UP

- ❖ Oppression
  - S. 227(2): a shareholder may apply for an order remedying oppressive or unfairly prejudicial conduct
    - “shareholder” includes any person the court considers appropriate
      - Hasn’t really been considered in BC yet, could be employee, environment? Who knows.
  - s. 227(3): court has broad remedial power
- ❖ Winding Up
  - S. 324(1), court can order a company liquidated and dissolved if “just and equitable” to do so
    - Application can be made by a broad class, expressly including creditors
- ❖ Hard to prove oppression (must prove conduct was harsh, wrongful or lacking in fair dealing), easier to get a winding up order as “just and equitable” is read more broadly

### OTHER REMEDIES

- ❖ Derivative actions (s. 232)
  - Where company fails to prosecute or defend a legal proceeding a shareholder (or any other person court considers appropriate) can prosecute the action in the name of the company
- ❖ Dissent rights (s. 237)

- Certain proceedings (amalgamations, for example) trigger dissent rights. Allow shareholders to receive fair value for their shares rather than participate in the transaction
- ❖ Court ordered inspection (s. 248)
  - Allows court to order an inspection into the dealings of the company if reasonable grounds exist to believe that oppression, fraud, dishonesty or unlawful conduct has occurred

## FIDUCIARY DUTIES

- ❖ Two main duties:
  - **Duty of Loyalty**
    - The obligation to act in the best interest of the corporation
  - **Duty of Care**
    - The obligation to use reasonable care when acting
  - **Numerous other duties**
    - In Ontario there are estimated to be over 200 federal and 125 provincial duties on directors

### I.A DUTY OF LOYALTY

- ❖ The corporation (the beneficiary) is in a position of vulnerability to the director or officer (the fiduciary) who has the discretion to act on the corporation's behalf (sometimes called the "Agency Problem")
- ❖ To address this vulnerability, corporate statutes require directors and officers to *act honestly and in good faith with a view to the best interests of the company\**
  - \*BC Business Corporations Act, S. 142(1)(a); Canada Business Corporations Act s. 122(1)(a)

### I.C DUTY OF CONFIDENTIALITY

- ❖ Directors must protect information that is proprietary or confidential to the company
- ❖ Can lead to conflicts
  - A director appointed by an investor is obliged to keep confidential information confidential from the shareholder that appointed them

### I.D DUTY OF CANDOUR

- ❖ If a director knows something that relates to a vital aspect of the company's business, it must be disclosed
- ❖ Can lead to conflicts, especially for a director who is also an officer of an investor who may be in competition

## II. DUTY OF CARE

- ❖ The obligation to *exercise the care, diligence and skill that a reasonably prudent person would use in comparable circumstances*

- ❖ Directors do not have to be infallible, but they are compared to a *reasonably prudent person*. Overly reckless and overly conservative behaviour will not meet this test
- ❖ Context counts as that standard requires the circumstances to be considered

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#### II.A HOW TO MEET DUTY OF CARE

- ❖ Ask Questions. Gather information from management and appropriate outside advisors. Consider all options carefully and then decide.
- ❖ Perfection is not required, but prudence is.
- ❖ Courts will not tolerate wilful ignorance
- ❖ Take the time required to make a proper decision, but courts will take into account urgency when assessing the decision made
- ❖ Be able to demonstrate that a reasonable process was followed

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#### II.B SPECIAL SKILLS

- ❖ Directors are often chosen because they have a particular skill (financial, engineering, legal)
- ❖ All directors are subject to the same duty of care
- ❖ directors with a particular skill will be expected to exercise that skill, but are subject to the same duty – they must exercise that skill as a reasonably prudent person would in similar circumstances
- ❖ Other directors can reasonably rely on the special skills of a fellow director

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#### II.C OTHER STAKEHOLDERS

- ❖ In BC, *Revlon* decision says just to the corporation, as below.
- ❖ The fiduciary duty is owed to the corporation, not its shareholders, employees, lenders or other stakeholders
- ❖ However, when taking actions, a director must consider the interests of the corporation's stakeholders
- ❖ This is not the same as owing them a duty and is poorly defined by the courts but if there are two paths open to a corporation, both of which lead to the same result, the path that takes into account the corporation's other stakeholders is the preferred one

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#### IV. CONFLICTS OF INTEREST

- ❖ Any director or officer could find themselves in a conflict position
  - For example, a director may own a building that the company wants to rent space in
  - A director may want to take an opportunity that could be pursued by the business (see *Canaero* discussion)
- ❖ The common law on conflicts is harsh: directors can have no interest in a contract with their company. If they do:
  - The company can terminate the contract without penalty
  - The director can be made to return any profit they made to the company

#### IV.A DISCLOSABLE INTERESTS

- ❖ Corporate statutes recognize that this isn't always workable so they created a safe harbour. If a director follows certain steps set out in the statute, they will be protected from being forced to disgorge profits. Those steps are basically:
  - Disclose the interest to the board in writing prior to executing the contract and abstain from voting to approve the contract
  - Have the other, uninterested directors approve the contract\*
- ❖ Some statutes also require the contract to be fair and reasonable to the company\*\*
- ❖ Directors should get specific legal advice in these cases because the rules must be precisely followed
  - \*BC Business Corporations Act, S. 147-153; \*\*Canada Business Corporations Act s. 120(7)(c)

#### DEFENCES

##### THE BUSINESS JUDGMENT RULE

- ❖ When assessing a directors actions, a court will not generally substitute their judgment for the decision of a director so long as, in reaching their decision, they acted consistently with their fiduciary duty and their duty of care (see *Re BCE Inc*)
- ❖ Decision does not have to have been the "best" decision, but had to be a decision that is within the bounds of reasonableness with a view to process and substance (see *Peoples v. Wise*)

##### DUE DILIGENCE

- ❖ In many cases a director or officer will have a defense to an allegation of breach of duty if they can demonstrate that they acted with "due diligence" (s. 157)
- ❖ Important to be able to demonstrate the steps taken so as to establish the defence – good minutes are essential
- ❖ Reasonable reliance on management, financial statements or outside advisors can all assist in establishing the defence, but reliance must be in good faith

#### SUMMARY OF FIDUCIARY DUTIES

- ❖ Two duties: duty of loyalty and duty of care
- ❖ Must avoid conflicts of interest
- ❖ Courts will be reluctant to substitute their judgment for the judgment of the directors and officers so long as they acted within the bounds of reasonableness
- ❖ Due diligence can establish a defence – but it must be documented and reliance on others must be in good faith.



## CASES

### CANAERO V. O'MALLEY

- ❖ Corporate Opportunity Doctrine
- ❖ O'Malley was a director of Canaero.
- ❖ In July 1966 he pursued a survey contract in Guyana for Canaero.
- ❖ He resigned from Canaero in August 1966 and shortly after signed the survey contract in the name of his new Company, Terra Surveys
- ❖ Canaero argued that this breached his duty of loyalty as the opportunity belonged to the company
  - "In my opinion, this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired." p. 607

### PEOPLES V. WISE

- ❖ Standard of care case
- ❖ Peoples and Wise shared inventory system
- ❖ Directors were alleged to have favoured one stakeholder over another when Peoples failed
- ❖ Duty of care was a subjective test at common law, statute made it an objective test (para 63)
- ❖ "Directors and officers will not be held to be in breach of the duty of care ... if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known." (para 67)
- ❖ Articulated business judgment rule:
  - "... it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made." (para 67)

### BCE INC. V. 1976 DEBENTUREHOLDERS

- ❖ A plan of arrangement was being voted on for an LBO of Bell Canada
- ❖ Shareholders voted overwhelmingly in favour but noteholders objected as it would increase the leverage on the company and cause value of existing bonds to drop by an estimated 20%

- ❖ Oppression action was brought (among other causes of action)
- ❖ **Read paras 36-41, especially:**
  - “In considering what is in the best interests of the corporation, directors may look to the interests of, inter alia, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. Courts should give appropriate deference to the business judgment of directors who take into account these ancillary interests, as reflected by the business judgment rule. ... It reflects the reality that directors ... are often better suited to determine what is in the best interests of the corporation.”
- ❖ Only get paid opinion fee if they ask for it, make sure in writing.

## EMPLOYEES

### EMPLOYMENT CONTRACTS

#### ❖ **Why have them?**

- Duties, Reporting Obligations
- Salary & Benefits
- Vacation Entitlements
- Incentive Plans
- Severance Entitlements
- Restrictive Covenants (Non-solicitation, Non-Compete)
- Intellectual Property Ownership
- Keep general and maintain flexibility for change in duties, reporting channels, corporate policies and benefits package.
- *Not all employees need all of these terms in their agreements*

#### ❖ **Form of Contract**

- Basic offer letter/agreement
- Mid-level Agreement
- Executive Employment Agreement

#### ❖ **Timing**

- Before first day on the job.
- Once employment starts, it may be too late.
  - Need fresh consideration if employment has already started – otherwise employment contract may not be enforceable.
  - Employee might just say no.

### FORM OF CONTRACT

#### ❖ **Basic Offer Letter / Agreement**

- Lower level employees generally do not need comprehensive employment agreements.
- Employer should be mindful of the sophistication of their employee.
- A basic offer letter outlining key terms of employment (salary, hours of work, termination) will generally be sufficient for lower level employees.
- Lower level employees are unlikely to obtain counsel prior to accepting an offer of employment - presenting a legally unsophisticated employee with a comprehensive employment agreement filled with legal jargon will be intimidating and difficult for that employee to understand.

#### ❖ **Mid-level Agreement**

- Mid-level employees may be presented with more substantial employment agreements.
- Generally contain more comprehensive provisions regarding bonuses, restrictive covenants, and more detailed termination entitlements.

#### ❖ **Executive Employment Agreement – quite comprehensive, well negotiated**

- Senior and executive level employees should /may be presented with comprehensive executive employment agreements.
- Executive level employees are likely to seek counsel before entering into any agreement.
- Employer should be mindful that an employee may attempt to negotiate the terms of this agreement.

## BOILER PLATE

### ❖ **Entire Agreement Clause:**

- Reference other agreements that form part of the employment contract package to establish “consideration”: Stock Option Plan, Non-Competition Agreement, etc.

### ❖ **Modifications**

- Changes only in writing, signed by both parties:
  - Conduct can vary the terms of the contract – want to avoid this where possible.
- If there’s a change to the employment contract, must update the contract or it could become unenforceable.

### ❖ **Severability Clauses**

## TERMINATION PROVISIONS

- ❖ Termination for just cause – no notice/severance
- ❖ Termination without just cause – notice/severance entitlements
  - Can be difficult to establish cause
  - Can define “cause” to include events that would not constitute cause at common law.
  - Always ensure that “cause” is defined to reference the common-law standard – do not limit termination to specific events.
- ❖ **Just Cause:**
  - No hard-and-fast rule for determining just cause.
  - Each case must be determined on its facts.
  - Employers must be able to prove that the employee’s conduct or behaviour was so serious in its nature or extent that it effectively breached the employment agreement.
  - Examples of serious/extreme misconduct that justify immediate dismissal for cause include:
    - Theft
    - Dishonesty
    - Violence
    - Willful misconduct
    - Regular or recurring neglect of duty
    - Disobedience
    - Conflict of interest
- ❖ **Without Just Cause:**
  - Termination without cause is lawful if done correctly.
  - Reasons for termination can vary from economic reorganization to unsatisfactory work performance, etc.

- Employee terminated without cause - entitled to, and must receive, notice of termination.
- Notice can = severance payment (duration of notice goes to quantum)
- If proper notice is not given = wrongful dismissal.

## TERMINATION PROVISIONS

- ❖ Provincial legislation - sets out minimum employment standards:
  - entry level, line worker
- ❖ Cannot contract out of statutory standards.
- ❖ Common law sets higher standards:
  - general rule 1 month per year of service
  - typically capped at 18-24 months
- ❖ Employment Contract - severance obligation, cannot be less than the statutory requirements.
- ❖ Often try to get employees to sign a release/waiver in order to pay out severance within 48 hours, make sure that's in the contract or employees may be unwilling to sign it.

## BC EMPLOYMENT STANDARDS

- ❖ **Requirements of this Act cannot be waived**
  - s. 4 The requirements of this Act and the regulations are minimum requirements and an agreement to waive any of those requirements, not being an agreement referred to in section 3 (2) or (4) [*collective agreements*], has no effect.
- ❖ **If employment is terminated**
  - s. 18 (1) An employer must pay all wages owing to an employee within 48 hours after the employer terminates the employment.
  - (2) An employer must pay all wages owing to an employee within 6 days after the employee terminates the employment.
- ❖ **Liability resulting from length of service**
  - s. 63 (1) After 3 consecutive months of employment, the employer becomes liable to pay an employee an amount equal to one week's wages as compensation for length of service.
  - (2) The employer's liability for compensation for length of service increases as follows:
    - (a) after 12 consecutive months of employment, to an amount equal to 2 weeks' wages;
    - (b) after 3 consecutive years of employment, to an amount equal to 3 weeks' wages plus one additional week's wages for each additional year of employment, to a maximum of 8 weeks' wages.
  - (3) The liability is deemed to be discharged if the employee
    - (a) is given written notice of termination as follows:
      - (i) one week's notice after 3 consecutive months of employment;
      - (ii) 2 weeks' notice after 12 consecutive months of employment;

- (iii) 3 weeks' notice after 3 consecutive years of employment, plus one additional week for each additional year of employment, to a maximum of 8 weeks' notice;
- (b) is given a combination of written notice under subsection (3) (a) and money equivalent to the amount the employer is liable to pay, or
- (c) terminates the employment, retires from employment, or is dismissed for just cause.

## FIDUCIARIES

### ❖ Special considerations given to fiduciaries.

#### ❖ **Who:**

- Employees with discretion to act unilaterally – affect the business:
  - typically senior managers/officers
  - consider actual duties/relationship, not titles
- General rule:
  - employees are free to leave their employment and compete, provided they do not use their former employer's confidential information.
  - employees who are fiduciaries are limited in what they can do post-employment.
- Fiduciary duties can be contractual or implied (i.e., obligations apply even without a contract)

#### ❖ **What:**

- Fiduciary duties prevent former employees from:
  - Directly soliciting customers, employees and suppliers;
  - Using or disclosing the confidential information of their former employer; and
  - Taking maturing business opportunities.
- Duration: Fiduciary duties continue after the employment relationship ends for a “reasonable period of time”.

## RESTRICTIVE COVENANTS

### ❖ **Why:**

- Contractual covenants can restrain a departing employee from:
  - competing against their former employer; and
  - soliciting the former employer's customers and employees.

### ❖ **TEST:**

- Any post-employment restrictive covenant beyond what is “**reasonably required**” to protect the employer's proprietary rights is unenforceable:
  - Duration
  - Scope
  - Territory

### ❖ **Commercial Context vs Employment Context**

- Courts typically do not interfere with the business judgment of a negotiated non-compete in a commercial context, unless exceptional circumstances prevail.
- Courts recognize employer's legitimate interest in safeguarding confidential business information and relationships with clients / suppliers - but will refuse to

enforce restrictive covenants that unduly restrict an employee's ability to earn a livelihood after the employment relationship ends.

## NON-COMPETITION PROVISIONS

### ❖ **What is Reasonable in the Employment Context?**

- protects a proprietary interest;
- reasonably defines the business definition, and geographic and temporal scopes;
- is free from vagueness and uncertainty; and
- is not otherwise contrary to the public interest.

### ❖ **Proprietary Interest Entitled To Protection**

- Proprietary interest of employer must involve confidential information, trade secrets, or business goodwill:
  - client lists,
  - trade connections and trade secrets,
  - ways of conducting business that are unique from competitors,
  - marketing strategies and pricing policies, and customary referrals from other businesses.

### ❖ **Business Definition, Geographic Scope and Temporal Scope**

- Must not be overbroad relative to the business interest employer is attempting to protect.
  - Business Definition: The scope of activities that an employee is prohibited from conducting.
  - Geographic Scope: The area in which a former employee is prohibited from engaging in certain activities.
    - Avoid the blue pencil approach
    - ***Payette v Guay Inc., 2013 SCC 45***
      - ◆ [A] territorial limitation is not absolutely necessary for a non-solicitation clause... in the context of the modern economy, and in particular of new technologies, customers are no longer limited geographically, which means that territorial limitations in non-solicitation clauses have generally become obsolete
  - Temporal Scope: the duration for which that covenant remains in effect.

### ❖ **The Restrictive Covenant is Free from Vagueness and Uncertainty**

- An employee must be able to know with certainty when he will or will not be in compliance with a restrictive covenant.
  - Example: Prohibiting contact with any client in which the employee had "dealings" is too vague
    - "dealings" could mean any number of things, including fleeting contact with the clients of other employees
    - the covenant is ambiguous
  - Contacts that employee negotiated product sales agreements in the last 12 months of employment, whether or not the agreement concluded

### ❖ **Not Otherwise Contrary to the Public Interest**

- Courts follow the general rule:

- non-competition covenants are contrary to public interest when a non-solicitation covenant (instead) would adequately protect the business interests of an employer.
- Non-competition covenants are only upheld in exceptional situations.
- **Atkinson Rule** – Employer breach of contract = termination of contract and release of restrictive covenants.
  - Issue in the case of wrongful termination (e.g., constructive dismissal, insufficient notice / severance).

## NON-SOLICITATION PROVISIONS

- ❖ **What is it:**
  - Prohibits ex-employee from soliciting current employees, customers and suppliers in relation to a rival business
- ❖ Will not be enforceable if it unduly restricts gainful employment
- ❖ Rarely longer than 1 year (e.g., one full business cycle)
- ❖ Draft separately from the non-compete (include a severability clause)

## INTELLECTUAL PROPERTY OWNERSHIP

- ❖ **What is it:**
  - patentable inventions
  - copyright (software, written works)
  - industrial designs
  - circuit topographies
- ❖ Common law presumption: inventions are the property of the employee
- ❖ **Can be rebutted by employer:**
  - contractual terms – employment contract
  - fiduciary obligation – invention related to the business
  - employed to invent / innovate
- ❖ **Some statutory protection for employers:**
  - Copyright Act
  - Industrial Design Act
  - Integrated Circuit Topography Act

## COPYRIGHT ACT

- ❖ **Ownership of Copyright**
  - **13. (1)** Subject to this Act, the author of a work shall be the first owner of the copyright therein.
  - (2) [Repealed]
  - **Work made in the course of employment**
  - (3) Where the author of a work was in the employment of some other person under a contract of service or apprenticeship and the work was made in the course of his employment by that person, the person by whom the author was employed shall, in the absence of any agreement to the contrary, be the first owner of the copyright,



but where the work is an article or other contribution to a newspaper, magazine or similar periodical, there shall, in the absence of any agreement to the contrary, be deemed to be reserved to the author a right to restrain the publication of the work, otherwise than as part of a newspaper, magazine or similar periodical.

❖ **Copyright Act - Moral rights**

- **14.1** (1) The author of a work has, subject to section 28.2 [*Nature of Right of Integrity*], the right to the integrity of the work and, in connection with an act mentioned in section 3, the right, where reasonable in the circumstances, to be associated with the work as its author by name or under a pseudonym and the right to remain anonymous.
- **No assignment of moral rights**
- (2) Moral rights may not be assigned but may be waived in whole or in part.
- **No waiver by assignment**
- (3) An assignment of copyright in a work does not by that act alone constitute a waiver of any moral rights.
- **Effect of waiver**
- (4) Where a waiver of any moral right is made in favour of an owner or a licensee of copyright, it may be invoked by any person authorized by the owner or licensee to use the work, unless there is an indication to the contrary in the waiver.

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INDUSTRIAL DESIGN ACT

❖ **First proprietor**

- **12.** (1) The author of a design is the first proprietor of the design, unless the author has executed the design for another person for a good and valuable consideration, in which case the other person is the first proprietor.

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INTEGRATED CIRCUIT TOPOGRAPHY ACT

❖ **Deemed creator of topography**

- (4) For the purposes of this Act, where a topography is created in the course of employment or pursuant to a contract, the employer or party to the contract for whom the topography was created shall be deemed to be the creator of the topography unless the employer and employee or the parties to the contract, as the case may be, otherwise agree.

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EMPLOYMENT AGREEMENTS

- ❖ Employment agreements claim ownership and require assignments of IP and agreement to waive moral rights from time to time.
- ❖ Produced in the course of employment?
  - broaden the statutory definitions
  - after hours and offsite
  - fiduciary obligation – invention related to the business
  - Employed to invent / innovate
  - garage hobby – Jobs/Wozniak

## TRADE SECRETS

### ❖ **What is it?**

- Non-public information about the company / business, obtained as a result of employment.
- Focus is on the nature of the information and the nature of the relationship between the relevant parties, including the specific circumstances which resulted in disclosure:
  - special know-how
  - Commercial
  - Financial
  - Industrial
  - Technical
  - Scientific nature

### ❖ Protected by breach of confidence obligations

### ❖ **Employer must show that the information:**

- Is secret
- Duty of confidence by employee:
  - fiduciary
  - Contract

### ❖ *Has to be more than industry standards commonly used*

## CHANGES TO EMPLOYMENT CONTRACTS

### ❖ Change can lead to constructive dismissal:

#### ➤ *Farber v. Royal Trust Co. (SCC):*

- Employer unilaterally makes substantial changes to the essential terms of an employee's contract of employment and the employee does not agree to the changes and leaves his or her job, the employee has not resigned, but has been constructively dismissed.
- By unilaterally making substantial changes to the essential terms of the employment contract, the employer is ceasing to meet its obligations and the employee can treat the contract as resiliated for breach and can leave.
- In such circumstances, the employee is entitled to compensation in lieu of notice and, where appropriate, damages.

### ❖ Test: Did the changes imposed by the employer substantially alter the essential terms of the employee's contract of employment without reasonable prior notice having been given.

### ❖ Proper consideration – basic contract law principles

### ❖ Careful of duress situations

## INDEPENDENT CONTRACTORS

### ❖ **Purpose:**

- Short(er) term commitments
- Avoid paying reasonable notice of termination

- Avoid providing company benefits
- Avoiding deducting and remitting taxes
- ❖ **Indicia of employment:**
  - Level of control or supervision
  - Exclusivity
  - Ownership of tools
  - Chance of profit and risk of loss
  - Integration
- ❖ **Risks:**
  - Tax liability
  - Wrongful Dismissal
- ❖ *If it looks like a duck, walks like duck, talks like a duck . . . . .*

## EQUITY PARTICIPATION

- ❖ What is it:
  - Share grants
  - Stock options /Employee Share Ownership Plans
- ❖ Benefits:
  - Sweetener to lower pay in start-up phase
  - Employees think like owners
  - Big payout gamble
- ❖ Disadvantages:
  - Minority shareholders
  - Ex-employees / disgruntled employees
  - Lack of Liquidity
  - Tax

## SHARE GRANTS

- ❖ Issue shares from treasury:
  - CRA – fair market value added to income
  - Must be paid for at the time of issuance:
    - Cash
    - Property
    - Past services
    - No future services
    - Not a Promissory Note

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### CBCA S. 25

- ❖ **S. 25**
- ❖ **Consideration**
- ❖ (3) A share shall not be issued until the consideration for the share is fully paid in money or in property or past services that are not less in value than the fair equivalent

of the money that the corporation would have received if the share had been issued for money.

❖ **Consideration other than money**

- ❖ (4) In determining whether property or past services are the fair equivalent of a money consideration, the directors may take into account reasonable charges and expenses of organization and reorganization and payments for property and past services reasonably expected to benefit the corporation.

❖ **Definition of “property”**

- ❖ (5) For the purposes of this section, “property” does not include a promissory note, or a promise to pay, that is made by a person to whom a share is issued, or a person who does not deal at arm’s length, within the meaning of that expression in the [Income Tax Act](#), with a person to whom a share is issued.

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BCBCA S. 25(3) 7 (5)

❖ **Payment of consideration for shares**

- 64 (1) In this section, “property” does not include
- (a) money, or
  - (b) a record evidencing indebtedness of the person to whom shares are to be issued.
- (2) A share must not be issued until it is fully paid.
- (3) A share is fully paid when
- (a) consideration is provided to the company for the issue of the share by one or more of the following:
    - (i) past services performed for the company;
    - (ii) property;
    - (iii) money, and
  - (b) the value of the consideration received by the company equals or exceeds the issue price set for the share under section 63.
- (4) The directors must satisfy themselves that the aggregate value of the past services, property and money referred to in subsection (3) (a) of this section equals or exceeds the issue price set for the share under section 63 and in doing so must not attribute to those past services or that property a value that exceeds the fair market value of those past services or that property, as the case may be.
- (5) In considering whether the aggregate value of the past services, property and money referred to in subsection (3) (a) of this section equals or exceeds the issue price set for the share under section 63, the directors may take into account reasonable charges and expenses that
- (a) have been incurred by the person providing the past services, property and money, and
  - (b) are reasonably expected to benefit the company.

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SUMMARY

- ❖ Preferable to transfer shares from founder
- ❖ Bonus payment to employee to fund purchase

- ❖ Beware of backdating
  - **Code of Professional Conduct for BC - Dishonesty, fraud by client**
    - **3.2-7** A lawyer must not engage in any activity that the lawyer knows or ought to know assists in or encourages any dishonesty, crime or fraud.

## STOCK OPTIONS

- ❖ **What is it?**
  - A contractual right, without the obligation, to buy a *stock* at an agreed-upon price within a certain period or on a specific date.
  - Typically vest over-time (golden handcuff)
    - Typically a percentage of the grant vests each year (e.g., 25% /year over 4 years)
    - Usually must remain employed throughout each vesting period
    - Only vested options can be exercised
    - Exercise period can vary (e.g., anytime during first fiscal quarter of each year)
  - Incentive for employees (typically not given to founders, they get shares outright)
- ❖ **Stock Option Plan**
  - Rules that govern the granting of options
    - Percentage of company, number of shares available
    - Maximum term for the plan:
      - 10 years (TSX)
      - Open-ended (Private) – rare to see
    - How to set exercise price
    - Anti-dilution provisions
    - May have Shareholder Agreement provisions
    - Restrictions on transfer (except to the estate)
  - Option
    - Particulars of grant
    - Number of Options
    - Vesting
    - Strike price

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## ACCOUNTING

- ❖ Companies now have to amortize the fair market value of the option as at issue date over the vesting period
  - Required by IFRS (International Financial Reporting Standards)
  - Difficult for private companies – no market to value the shares
  - Valuation - \$\$
- ❖ Strike price should be fmv at time of grant to give capital gains treatment to employee (otherwise, income inclusion at time of exercise)
- ❖ In the money stock options:
  - Grant stock value > strike price
  - Exercise only makes sense if options are in the money
  - Hard to tell if shares aren't listed / liquid

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## TAX TREATMENT

- ❖ Grant of option is not taxable
- ❖ **Employee taxed at time of exercise, even where employee continues to hold the shares**
  - Difference of strike price and fmV added to income if strike price was < fmV at time of grant
  - Evidentiary issue for private companies
  - Capital gains treatment at time of exercise if at time of grant strike price = fmV
  - Tax burden on employee is at time of exercise:
    - If shares aren't liquid – mismatch of tax burden and cash flow
  - Cashless / shareless exercise:
    - At time of exercise, company doesn't issue shares, but instead, pays option holder the difference between the strike price and the fmV of the share
- ❖ **CCPC – at time of grant:**
  - employee taxed when share is sold, not when option is exercised
  - In-the-money options at time of grant taxed at capital gains rates if shares held for 2 years following exercise of option
- ❖ Always understand the tax effect on employees – could inadvertently create financial problems

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## ISSUES

- ❖ **Compatibility with exit strategy:**
  - IPO – exchange rules
    - Options must be < 20% issued shares
    - TSX:
      - maximum 10 year term on option plan
      - no more than 5% outstanding shares / year for any one person
      - Options held only by officers, directors, employees, consultants (bone fide services, significant time and attention to company's affairs)
  - private take-over <100% (minority shareholders)
    - Drag along / tag along provisions
- ❖ **Compatibility with employment issues:**
  - How to deal with vested options on termination
  - Disgruntled employees holding shares
  - Loss of unvested options – without compensation
  - Valuation issues
  - Usually addressed in plan, sometime in employment contract

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## REPRICING OPTIONS

- ❖ **When FMV of shares fall below strike price:**
  - Lost incentive
  - No repricing option to motivate employees

- TSX rule – cancellation and reissuance in 12 month period treated as repricing to be approved by shareholders
- Can just issue new options – mindful of 20% rule
- Valuation issue to show fmV of the shares has really dropped.
- Same tax issues apply on repricing as though the options were freshly granted (e.g., for capital gains treatment repricing cannot be in-the-money at time of adjustment)

## PRIVATE FINANCING

### FINANCING ROUNDS

- ❖ Typical to go through several financing rounds:
  - Founder Seed Capital
    - Typically enough to get started
    - Sweat equity stage
  - Friends and Family Round
    - Investing in the Founder
  - Angel Investor
    - Business angel – mentoring relationship
    - Dragons Den
  - Venture Capital
    - Minority interest
    - Often shared in a syndicate
  - Rounds will never be enough to where the business will be profitable, maybe get it to the R&D stage, market testing, etc. – always one phase at a time, it's high risk so the investors want to be able to re-evaluate at each step. Low liquidity.

### SECURITIES LAWS

#### GENERAL

- ❖ Securities laws don't just apply to companies listed on stock exchanges.
  - Securities laws apply to any issuer, incorporated or unincorporated, listed or not.
- ❖ Securities regulations specify how securities can be issued.
  - Who is buying the securities and where are they from? From across Canada – must worry about the laws in each province that they're in.
- ❖ Misconception that securities laws only apply to public companies – many start-up and early stage issuers offside in financing rounds.
- ❖ Jurisdiction of investor.

#### BC

- ❖ **Two basic requirements underlying our securities laws:**
  - **Registration** – Every person who “trades” (sells) securities must be registered (licensed) with the Commission.
    - Intended to ensure that people selling securities are knowledgeable and able to properly advise investors.
  - **Prospectus** – Every person who “distributes” (trades) previously unissued securities (ie, new securities being issued for the first time) must file and obtain a receipt for a prospectus with the Commission.
    - Prospectus – comprehensive document that discloses all material information about the issuer and the securities being sold.



- Ensures that investors receive sufficient information to allow them to make an informed decision.
- ❖ **Security has a broad legal meaning**
  - Common and preferred shares
  - Options, warrants and other convertible instruments
  - Debentures, notes and other instruments of indebtedness
  - Limited partnership units
  - Memberships in co-operative associations
  - Units in a resort property (sharing in the rental profits for the whole building or property)
- ❖ Every issuer must comply with the registration and prospectus requirements or rely on an exemption from those requirements
- ❖ Non-compliance without an exemption = violation of BC securities laws. May result in penalties.

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## BC EXEMPTIONS

- ❖ Growth companies must rely on exemptions:
  - Private issuer exemption
  - Family, friends and business associates exemption
  - Employee, director, officer and consultant exemption
  - Accredited investor exemption
  - \$150,000 exemption
  - Offering memorandum exemption
- ❖ No application to the Commission to use any of these exemptions.
- ❖ Must meet all of the conditions of the exemption.

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## PRIVATE ISSUER EXEMPTION

- ❖ **A private issuer means a person that:**
  - Is not a reporting issuer, mutual fund or pooled fund
  - Has less than 50 security holders, excluding employees and former employees
  - Has restrictions on the transfer of its securities in its articles, memorandum, bylaws or its shareholders agreement
  - Has sold its securities only to the persons in the exemption list
- ❖ **Issue securities to:**
  - Directors, officers, employees or control persons of the issuer
  - Family members (spouse, parent, grandparent, sister, brother or child) of the directors, senior officers or control persons, close personal friends or close business associates of the directors, senior officers or control persons
  - Current security holders
  - Family members of the selling security holder
  - Accredited investors

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## FAMILY, FRIENDS & BUSINESS ASSOCIATES EXEMPTION

- ❖ Can sell securities in any amount without providing any disclosure:

- A director, senior officer or control person of the issuer
- A family member (defined above) of a director, senior officer or control person of the issuer
- A close personal friend or close business associate of a director, senior officer or control person
- ❖ No limit on the number of purchasers or the amount of money that can be raised.
- ❖ For large number of purchasers, the Commission may question exemption.

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#### EMPLOYEE, DIRECTOR, OFFICER & CONSULTANT EXEMPTION

- ❖ **Issuer can sell securities in any amount without providing any disclosure:**
  - Employees
  - Directors
  - Senior Officers
  - Consultants
- ❖ Purchaser must be buying the security voluntarily
- ❖ This means that the purchaser has not been persuaded to buy the security due to a promise that he or she will be, or will continue to be, employed appointed or engaged by the issuer.
- ❖ Used by growth companies as part of compensation package for justifying low wages.

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#### ACCREDITED INVESTOR EXEMPTION

- ❖ Can sell to an AI in any amount without giving disclosure about the issuer.
- ❖ No limit on the number of purchasers or the amount that can be raised.
- ❖ An accredited investor includes:
  - Financial institutions, pension funds
  - Registered advisers or dealers
  - Persons buying at least \$150,000 of securities
  - Corporations, limited partnerships, trusts or estates having net assets of at least \$5MM.
  - Individuals who have at least \$1MM in financial assets (cash and securities) before taxes.
  - Individuals whose net income before taxes excludes \$200k (or \$300k combined income with spouse) in last two years and will for current year
  - Individuals who have at least \$5MM in net assets.
- ❖ *Must meet at each stage of investments – if it changes, re-evaluate*

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#### OFFERING MEMORANDUM EXEMPTION

- ❖ Lets issuer sells its securities to anyone, regardless of their relationship, wealth or the amount of securities purchased.
- ❖ Can only be used by an issuer selling its own securities (eg, not for a transfer of existing shares from a shareholder)
- ❖ Issuer must:
  - Obtain a signed risk acknowledgement form from the purchaser, and
  - Deliver an offering memorandum, prepared in the required form, to the purchaser

- ❖ Must file the offering memorandum with the Commission within 10 days of selling the securities.
- ❖ **What is a risk acknowledgement form?**
  - Clear, blunt statement of the risks associated with investing in securities when they are sold under an exemption.
  - Bold print immediately above where the purchaser is required to sign: "I acknowledge that this is a risky investment and that I could lose all the money I invest"
- ❖ **What is the required form of offering memorandum?**
  - A non-reporting issuer must use a long form of offering memorandum, Form 45-105F2, that contains seven key elements:
    - Term sheet – a one-page description of the offering.
    - Use of proceeds – a table showing how the money will be used
    - Description of the issuer and its business
    - Description of any special features of the securities
    - Risk factors – with the issuer, its business, the securities
    - Purchaser's rights (cancel the purchase, action for misrepresentation)
    - GAAP financials. Interims by management, audited annuals.
      - Changed a few years ago, now follow the same financial standards as the rest of the world (aside from the US), IFRS
      - Must make sure financial info is prepared according to GAAP.
- ❖ The offering memo must contain a certificate that states: "This offering memorandum does not contain a misrepresentation"
- ❖ A misrepresentation is an untrue statement of a material fact or an omission to state a material fact.
- ❖ This statement in the certificate must be true when the offering memo is given to the purchaser AND when the purchaser signs the purchase/subscription agreement.
- ❖ **Purchasers rights under Offering Memorandum:**
  - Right to cancel the purchase for two business days after the purchaser signs the purchase/subscription agreement and has written the cheque and given it to the issuer.
    - Must hold the purchase funds in trust for the purchaser
    - Should hold the purchaser's cheque without cashing it until the cancellation period has expired.
  - A right of action if there is a misrepresentation in the offering memo. Can sue for rescission (to cancel the agreement) or sue for damages.

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#### SHOTGUN TAKE OVER EXAMPLE

- ❖ There was a family that wanted to build a hotel as a tourist attraction. Very expensive to do so.
- ❖ Group of investors banded together to invest.
- ❖ Had a basic shotgun clause, set up as though there were only two investors.
  - Actually a bunch, family and the group of investors.
- ❖ 7 years go by, hotel was successful.
- ❖ Formula had occupancy of 80% all year round.

- ❖ Investors wanted to be bought out, went to family, they wouldn't/couldn't.
- ❖ Investors took it to E&Y, had no money though, wanted to trigger the shotgun clause.

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## STAGING INVESTMENTS

- ❖ What is it?
  - Fund enough for each stage of the business separately
  - Risk mitigation factor
  - Reassess at each stage
  - No commitment up front
  - May have a right to invest in further stages
- ❖ Constantly chasing rounds of financing
- ❖ Negotiating leverage

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## INVESTMENT INSTRUMENT

- ❖ Debt, equity, hybrid
- ❖ Equity has higher return potential, more risk.
- ❖ Convertible preferred shares
  - Start as a preferred share with a cumulative dividend for a specified return, convert to common shares to participate in upside growth
- ❖ Separate class of preferred = class voting rights on fundamental changes (sale of the undertaking, amalgamation, etc.)
- ❖ Can become a veto right on voting
- ❖ Typical to issue shares in series with each financing round to avoid the separate class problems

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## KEY ELEMENTS OF VC DEALS

- ❖ **Most VC deals will involve the following documentation:**
  - **Subscription Agreement** – A SA is made between the issuer company and the VC investor(s), in which the company gives reps and warranties with respect to its share capital finances and operations and the covenant to issue shares to the investors
  - **New Share Rights** – typically, the SA will provide that the investors will be subscribing for a new class of preferred shares that contain rights and preferences that rank in priority to all other classes of shares that the company may be authorized to issue. These share rights and restrictions can themselves be the subject of extensive negotiation.
- ❖ **Shareholders Agreement** - The Shareholders Agreement will usually provide for, among other items:
  - Rights for the investors to nominate one or more individuals to the board of directors of the investee company;
  - Restrictions on the type of conduct that can be undertaken by the company without “supermajority approval” or some other type of approval that ensures the involvement of the VS investors; and

- A drag along right that ensures that minority investors are “dragged along” in the event that a third party offers to purchase the shares of the investors in the company.
- ❖ **Updated Option Plan**
  - VC investors will also often require that the company amend and restate its management option plan to ensure that its investment is not diluted by the exercise of pre-existing (and inexpensive) options.
- ❖ **Legal Opinion**
  - Additionally, most VC investors will wish to receive an opinion of the issuer’s counsel which confirms, among other things, the authorized, issued and outstanding share capital and, in some cases, the enforceability of the transaction documents.

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## KEY ISSUES IN VC DEALS

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### KNOWLEDGE QUALIFICATIONS

- ❖ There is often significant discussion around which of the IP representations and warranties should be qualified by knowledge.
- ❖ Disagreement often occurs in connection with the qualification of the non-infringement representation and warranty, in which the company represents and warrants that its intellectual property rights do not infringe upon the IP rights of others.
- ❖ Most VC firms are very sensitive to the non-infringement representation and warranty given that much of their investment is predicated on the value and worth of the investee company’s IP and their ability to use that IP without restriction on a worldwide basis.

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### SHARE RIGHT ISSUES

- ❖ Detailed discussion of VC share rights could be a presentation in itself, but there is often negotiation over the following points in any set of share rights:
  - Ratchet Adjustments – in the event that a company, subsequent to the VC financing, issues equity at a price per share (barring any reorganizations or subdivisions) lower than the price paid by the VC investor, some share rights provide that the investor will receive additional shares of the investee company to protect it from any price dilution.
  - *Note that issuance of “free” shares is a problem; typically addressed through adjustments to conversion ratio.*
- ❖ **Double Dipping**
  - Some preferred share rights will contain a provision where, upon the winding up of the company, the preferred investor receives back its original subscription amount (the first dip) and, after receiving such funds, participates in the sharing of any remaining funds with the lower ranked shares, as if the preferred investor had converted into common shares (the second dip).

## DRAG ALONG RIGHTS

- ❖ Virtually all VC investors will insist that the articles, the shareholders agreement, or both, contain some form of drag along provision in which minority shareholders can be “dragged along” into a sale transaction in the event that a certain specified percentage of shareholders are willing to participate in the sale transaction.
- ❖ The drag along threshold is typically a negotiated point.
- ❖ Some recent deals in Vancouver have called into question the enforceability of drag along provisions, with the concerned parties maintaining that a drag along which provides that a share can be transferred “without any further action on the part of the dragged-along shareholder” is ineffective since share transfers require either the endorsement on the certificate or instrument of transfer to be delivered concurrently with the underlying share certificate.
- ❖ **Solution:** acquisition by way of plan of arrangement or use of power of attorney concept whereby attorney can endorse certificate.

## FOUNDER’S LIABILITY

- ❖ In first round VC investments, some investors will require one or more of the founders to guarantee or be jointly and severally liable with the company in connection with representations and warranties made by the company.
- ❖ Factors influencing an investor’s decision to ask for founder’s liability include:
  - The role the founder has played in the evolution and development of the company;
  - The valuation;
  - The customs of the VC investors; and
  - The pedigree of the founder.
- ❖ Where a founder agrees to be liable with the company in this regard, it is usual to see some protections built in so that the founder’s liability is not limited – eg, an overall cap on liability.

## REGISTRATION RIGHTS

- ❖ In VC deals involving investors from the US, it is common for such investors to request “registration rights” (usually in a free standing agreement) in which the company can be compelled, in certain circumstances, to register the shares of the company with securities regulators so that the VC investors are able to sell their shares in the public markets.
- ❖ Significantly, these rights are rarely asked for by Canadian VC investors, who seem to be of the view that a contractual provision which obliges a company to go public is not likely to be of much value if there is no real market for the offering.

## EXIT STRATEGIES AND SECURITIES LAWS

- ❖ **Investor exit strategy:**
  - IPO
  - Share redemption
  - Share purchase (Put/Call Option)

- ❖ Securities exemptions must apply to secondary trade
- ❖ **Becomes an issue when over 50 shareholders (excluding employees)**
  - Reporting issuer
  - Offer to all
- ❖ **Share redemption/repurchase**
  - Solvency test – tough for a start-up
  - Cash flow concerns
  - Empty right/remedy?
- ❖ **Forced Sale right:**
  - Right to sell the business as a contractual remedy
    - Appoint majority of the board
    - Voting agreement with principal shareholders to support the sale
    - Still have to discharge fiduciaries
    - High transaction costs
- ❖ **Dissent rights example** (sale for royalty to pay secured debt; 27% shareholder)
  - Royalty deal over 10 yr period; in year one
  - Company that bought out the business is more connected, will go out and flog the product, and every time they have a sale, there is a royalty paid back based on purchase price
  - Over 10 years, when royalties are paid, think they might get their investment back (25 mill), maybe up to 30 mill, losing money due to lack of interest
  - Royalties end up being worth zero
  - Discussion on fiduciary duties – took over board, made a deal good to them, so they may get the principal back, and no one else gets anything back;
    - did not exercise fiduciary duties, did what was in their own best interests (VCs)

## VENTURE DEBT FINANCING

### DEBT – UNLIKELY SOURCE OF CAPITAL

- ❖ Debt is an unlikely source of capital for growth companies
  - Not profitable so the ability to write off interest expense is of little use
  - Uncertainty leads to greater reorganization and bankruptcy risk
  - Large levels of debt in a venture company send the signal that it has been unable to find equity financing
- ❖ Yet debt is commonly used, just not straight debt

### MEZZANINE DEBT

- ❖ Often provided by individuals or venture capital funds
- ❖ Ranks 2<sup>nd</sup> in the priority chain:
  - Senior debt
  - Subordinated debt (Mezz debt)
  - Preference securities
  - Common shares
- ❖ High interest rate
- ❖ Often equity linked, or sold as units with warrants
- ❖ Warrant is the right to purchase a share, or some other security
  - Call is the same thing (for financial instruments – right to purchase)
- ❖ Not lent against tangible assets
- ❖ Mezz lenders want to see:
  - Sufficient cash flow to cover interest
  - Enterprise value as a going concern to determine amount of principal that can be lent
  - Increases in enterprise value to:
    - Attract future financing sources (debt or equity) who can pay out the loan
    - Give value to the equity component

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### MEZZ LENDERS

- ❖ Act like equity holders in good times and are often:
  - Sources of additional capital
  - Willing to defer interest or extend the term
  - Willing to convert to equity
- ❖ Act like lenders in bad times and will guard their spot on the priority chain
- ❖ Mezz debt is not venture debt
  - Venture debt is more like straight debt, used to bridge period between equity rounds
  - Becoming more common in Canada



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## CONTROL

- ❖ Mezz lenders' return is based in part on equity appreciation, so they are as concerned about control as a normal venture investor.
- ❖ Mezz loans have the normal covenants.
  - Dividend blocker, restricted payments, requirements to use equity raises to repay debt.
- ❖ But also include board representation
- ❖ Conflicts of interest are acute for lenders on boards
  - Actions can be seen to be favouring lenders over other stakeholders

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## EQUITY SWEETENER

- ❖ Fundamental to the structure of the mezz loan
  - Equity upside provides the return that the mezz lender is seeking
    - Interest is not sufficient (13% interest is high, but equity returns of 1000% may occur in successful growth companies)
  - Debt component provides downside protection
- ❖ Usual negotiation sees equity increases offset by interest decreases and vice versa

## WARRANTS VS. CONVERTIBLE DEBT

- ❖ Warrants allow the purchase of a certain number of shares, of a certain price, for a fixed period of time.
  - Ie. 100k shares for \$0.50/share with a two-year term
- ❖ Convertible debt has similar features but the exercise price is paid in debt, not cash
  - Result is that convertible debt disappears if exercised, the debt stays if warrants are exercised. If debt disappears:
    - Interest stops, covenants are gone
    - Can cause lender to hold off exercise so as to maintain interest payments
    - Some covenants (such as board representation) should be tied to continued equity participation in warrant deals

## INTEREST

- ❖ AKA "coupon", "basis points" or "points"
- ❖ Effective interest rate vs. nominal rate and lawyers vs. economists
  - For economists: nominal rate ignores compounding and time value of money; effective rate factors those in. Therefore, effective rate increases over nominal rate if there is more than one interest payment per year.
  - For lawyers: effective rate equals nominal rate plus all other fees and expenses that must be paid by the borrower.

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## INTEREST ACT

- ❖ S. 3 – if interest is specified but no rate is fixed, the rate is 5%

- ❖ S. 4 – except mortgages and hypothecs, interest payable for any period less than a year, must be expressed as a per year amount, or it can't exceed 5% (can trip up bridge lenders)
- ❖ **Smith v. Canadian Tire Acceptance**: applies only to nominal rate, not effective rate

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#### PENALTY INTEREST

- ❖ Mezz loans often provided for penalties on default
  - Gives borrower incentive to raise equity
  - Gives lender increased leverage when dealing with a defaulting company
  - More useful than seizing assets as growth company assets aren't usually that valuable
- ❖ S. 8 – if loan is secured by real property, the rate can't increase on default

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#### CRIMINAL CODE

- ❖ S. 347 – illegal to charge effective interest of over 60% per year
- ❖ Contains extensive definitions to ensure all fees and other creativeness gets caught in “effective interest” – including lender's legal fees, finder fees, stand by fees, bonuses, monitoring fees and commitment fees
- ❖ Provides common law defense of illegality to borrowers
- ❖ Can be inadvertently violated on short term loans and on early repayments
  - **Garland v. Consumers' Gas** – a late fee of 5% was charged on overdue accounts, even if only one day overdue. If repaid on first late day, effective rate was 1825% per year

#### SECURITY

- ❖ Mezz debt is usually subordinated to senior debt
  - Even when there is no senior debt in the company this language is in the loan agreement
  - Even when secured, it is second lien security, so it is secured by difference between the value of the company and the amount of the senior debt
  - However, senior lenders may not take security in assets of dubious value (shares, intellectual property) if it encourages more capital to come into the company
  - Share pledges are attractive to Mezz lenders – they allow increased control in a default scenario. Senior lenders don't want equity control

#### INTERCREDITOR AGREEMENTS

- ❖ Establishes how creditors will interact
  - Provides contractual priority over secured assets (additional to PPSA)
  - Caps maximum amount of debt parties can lend to borrower
    - Avoids company over extending itself
  - Governs how payments can be made after events of default
  - Gives senior lender 30-120 head start to enforce security

## COMPLEXITY

- ❖ Venture companies have immensely complex legal relationships once they are established:
  - Share purchase agreement with VS
  - Shareholder agreement
  - Escrow or pooling agreements
  - Option plans
  - Investor rights agreement
  - Share rights and restrictions
  - Employment agreements
  - NDAs

## THE THREE SHOCKS

- ❖ First: Realizing after the fifth amendment to the shareholders agreement that the negotiation is never over
- ❖ Second: Realizing that complexity allows hidden pitfalls to suddenly emerge (ie no requirement to provide for orderly market on IPO)
- ❖ Third: Realizing that the founders and the VCs are never truly on the same side

## REDUCE COMPLEXITY

- ❖ To avoid the three shocks:
  - Avoid duplicative or unnecessary terms
  - Put a good, independent board in place and push more decisions to them
  - When advising VCs, make sure they have the ability to be heard on the board (and perhaps take control)
- ❖ Founder-proof the company
  - Founders will leave: incent them to still be inclined toward the company even after departure

## PUBLIC FINANCING

### SECURITIES REGIME

- ❖ Each province and territory has its own securities act, securities regulator and securities rules
- ❖ Acts and rules are largely harmonized between jurisdictions
  - Though local variations do exist
- ❖ Federal government is trying to create a federal regulator
  - *AB and QC are challenging this initiative*
- ❖ Canada is the only developed country to have a fractured system like this.
  - US did for a while, but now has SEC, some states have their own but they only deal with things that are wholly within the state.
  - For Canada, they have to do stuff to try to get themselves into a more normal process
    - The issue is that no individual province is large enough to support a securities market on its own.
    - You can't buy and sell enough securities in any individual province to get adequate pricing
    - Markets work on a simple macroeconomic basis – supply/demand.
    - The more trading, the more pricing activity, the more information you have to price things properly.
    - Maybe mining companies in Canada, that's probably the only place.
    - Must be able to trade between provinces for a practical, functioning market.
    - Goal is to go out and promote a proper, functioning market.
    - Anomalies in pricing because they're too small.
    - Still enough differences in Canada that it makes sense to have consolidated act and regulations for BC, AB, and ON.
  - **Thing called the passport system in Canada.**
    - Allows one securities regulator to sign off on a particular issue, then it streamlines it for other regulators. ON does not participate in this system.
    - Plain English and common filing rules across the country, though QC requires in French.
    - Federal govt trying to fix, tried to put a national regulator in place, got shot down by the SCC.
  - New system is opt-in, though AB and QC are fighting it.

### WHAT IS REGULATED?

- ❖ Securities
  - Broadly defined, includes:
    - Any document evidencing an interest in the capital, assets, property, profits, earnings or royalties of a person or company
    - Any document evidencing an option, subscription or other interest in a security

- Any bond, debenture, note or other evidence of indebtedness, share, stock, unit, unit certificate, participation certificate ...
- ❖ Includes all types of debt and equity

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## SECURITIES ACT

- ❖ S. 34: A person must not “trade” in a security unless registered under the regulations or exempt from regulation
  - The “dealer registration requirement”
- ❖ S. 61: a person must not “distribute” securities unless pursuant to a prospectus or an exemption from the prospectus requirements
  - The “prospectus requirements”
- ❖ “Trade” defined broadly, includes “a disposition of a security for valuable consideration”, and any act in furtherance of a trade
- ❖ “Distribution” defined broadly, includes any trade of securities from treasury or by a control person.

## EXEMPTIONS

- ❖ Main exemption doesn’t require you to do anything, if you’re doing what a normal company does you’re probably within the exemption without realizing it.
- ❖ Dealer Registration Exemption
  - In BC, a person is exempt from the requirement to be registered to trade securities (the “dealer registration requirement”) if, among other things:
    - The person is not engaged in the business of trading in securities as a principal or agent (NI 31-103, s. 8.4)
  - This exemption is the most common one used by issuers and investors
- ❖ Regulation in Canada, for securities laws:
  - Securities Act for the individual province
    - Almost always skeleton legislation – push most off to the securities regulators
  - Securities Regulations
    - Also skeleton regulations – pass on the ability to make regulations to the regulator
  - National Instruments – NI (All provinces and territories)
  - Multilateral Instruments – MI (Some provinces and territories)
  - BC Instruments (BC)
  - Companion Policies (added to others)
  - BC Policies (local policies to the jurisdiction)
  - Distributions not made by prospectus are typically referred to as “private placements”

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## COMMON EXEMPTIONS

- ❖ Private issuer exemption
- ❖ Family, friends and business associates
- ❖ Accredited investor

- ❖ Offering memorandum
- ❖ Employees, directors, senior officers and consultants
- ❖ Minimum amount

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#### PRIVATE ISSUER EXEMPTION – NI 45-106, S. 2.4

- ❖ Can't be a reporting issuer
- ❖ Articles, bylaws or a unanimous shareholders agreement must restrict transfer of securities
  - Usually requires board approval for any transfer
- ❖ No more than 50 people excluding employees and former employees, can hold securities (other than non-convertible debt)
- ❖ Can't have distributed shares to the public (long list in exemption of who is not the public)
- ❖ No commission can be paid to directors, officers, founders or control persons on share sales, other than to accredited investors
- ❖ Securities are issued in certificate form
  - In numerical order, shows how many shares you own
  - In BC, evidence of who owns a security is the central securities registry
  - Whoever is on that register is a shareholder
  - Due to the distributed nature in which people hold securities now, people don't always hold the paper.

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#### FAMILY FRIENDS AND BUSINESS ASSOCIATES, S. 2.5

- ❖ Allows distributions to a list of persons, including founders, directors, executive officers, family and "close personal friends"
  - Do you know what colour their house is?
- ❖ Overlaps private issuer, but is still available even after issuer has sold shares to more than 50 persons or has sold shares to the "public"
- ❖ "Friends", directors and executive officers not available in ON

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#### ACCREDITED INVESTOR, S. 2.3

- ❖ Allows distributions to "sophisticated" persons
- ❖ Long list, includes:
  - Individuals with net financial assets in excess of \$1MM
  - Individuals with net income before taxes of \$200k for two most recent years (\$300k with spouse) who reasonably expects to exceed that amount in the current year
  - A person with net assets of at least \$5MM
- ❖ Does not include persons created for purpose of being an accredited investor

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#### OFFERING MEMORANDUM, S. 2.9

- ❖ BC Model
  - Deliver prescribed form of offering memorandum
  - Obtain signed risk acknowledgement

- ❖ AB Model
  - Above, plus only “eligible investors” can invest more than \$10k
- ❖ If province doesn’t statutorily provide it, issuer must:
  - Give a 2 business day contractual right of rescission
  - In case of misrepresentation, give a contractual right of rescission (180 days) or damages (3 days)
- ❖ No equivalent in ON
- ❖ Jurisdiction A, Jurisdiction B
  - Issuer/Offeror in A, Purchaser in B
  - In ON, the trade occurs where the purchaser is located.
    - If you trade out of the country, Canadian law doesn’t apply.
  - In AB and BC, trade occurs in both jurisdictions, where the purchase occurs and where the offer is from.

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#### EMPLOYEES, ETC. S. 2.24

- ❖ Allows distributions by issuer and control persons to employees, directors, senior officers and consultants
- ❖ Participation must be voluntary
- ❖ Not typically used in capital raising but useful in ON, where business associates exemption does not include directors and executive officers

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#### MINIMUM AMOUNT, S. 2.10

- ❖ Exemption available where:
  - Investor purchases as principal
  - Investment of at least \$150,000 paid in cash
  - Distribution is of the securities of a single issuer
- ❖ Not available if purchaser was created for purpose of making the investment (ie no pooling)
- ❖ Not typically relied on except in offshore bond offerings

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#### RESALE OF SECURITIES, NI 45-102

- ❖ The first trade of a security is deemed to be a distribution, therefore a prospectus or an exemption is required for first trades as well
- ❖ Two basic regimes
  - Restricted period (accredited investor; family, friends and business associates; offering memorandum; minimum amount)
  - Seasoning period (private issuer; employee, executive officer, director and consultant)

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#### RESTRICTED PERIOD, S. 2.5

- ❖ Resale is a distribution unless:
  - Issuer has been a reporting issuer for 4 months preceding trade
  - At least 4 months have elapsed from distribution date

- Private issuer securities must bear the following legend:
  - Unless permitted under securities legislation, the holder of this security must not trade the security before the date that is 4 months and a day after the later of (i) (insert the distribution date), and (ii) the date the issuer became a reporting issuer in any province or territory.
- Can't: be a control distribution; prepare/create demand; pay extraordinary commission for trade.

#### SEASONING PERIOD, S. 2.6

- ❖ First resale of any security after issuer ceases to be a private issuer is a distribution unless:
  - Issuer must have been a reporting issuer for 4 months preceding trade
  - Can't: be a control distribution; prepare market/create demand; pay extraordinary commission for trade

#### BECOMING A REPORTING ISSUER

- ❖ Private issuer becomes a reporting issuer by filing a prospectus
- ❖ Prospectus is a comprehensive disclosure document that discloses all material facts about the company and is accompanied by 3 years of audited income statements and 2 years of audited balance sheets
- ❖ Reporting issuers are subject to NI 51-102 and must provide continuous disclosure audited annual financials; unaudited quarterly; material change reports; annual and interim MD&A; insider trading reports.
- ❖ Venture issuers aren't required to have annual information forms.
- ❖ If you fail to comply, get put on list of defaulting issuers, prohibited from trading,

#### BECOMING LISTED

##### VENUES

- ❖ Becoming listed is different from becoming a reporting issuer
- ❖ Senior exchange in Canada is the TSX (Toronto Stock Exchange)
- ❖ Main venture exchange in Canada is the TSX-V
  - Vancouver Stock Exchange and Alberta Stock Exchange merged to form Canadian Venture Exchange (CDNX)
  - CDNX purchased by Toronto Stock Exchange and renamed TSX Venture Exchange (TSX-V)

##### REASONS FOR

- ❖ Access to capital
  - Securities issued by prospectus are free trading
  - TSX-V provides a market to trade those securities
  - A liquid market means more buyers which should mean better pricing for sellers



- Investors like the ability to exist investments in a market that has good pricing, if you can offer them that they are more likely to invest in your company
- Therefore, companies go public

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#### REASONS AGAINST

- ❖ Annual compliance costs are high (hundreds of thousands)
- ❖ Share price no longer determined by board; makes access to capital more sporadic
- ❖ Disclosing all material information can be a competitive disadvantage
- ❖ Control of venture can be lost by founders (whether to the rules of the exchange or to a take-over bid).

## PUBLIC MERGERS & ACQUISITIONS

### OBTAINING INFORMATION ABOUT THE TARGET

- ❖ **Canadian public companies are subject to a strict disclosure regime**
  - annual and interim consolidated financial information and MD&A
  - annual disclosure of operational information in prescribed form (Annual Information Form for TSX and some TSX-V issuers)
  - annual disclosure of governance and other management matters
  - Canadian disclosure regime is substantially the same as U.S.
  - [www.sedar.com](http://www.sedar.com)
  - 10%+ shareholders (and directors and officers) must file insider reports ([www.sedi.ca](http://www.sedi.ca))

### STRUCTURING THE TRANSACTION

- ❖ Take-over bid pursuant to provincial securities laws:
  - OR
- ❖ A shareholder-approved transaction, i.e., amalgamation or plan of arrangement, pursuant to federal or provincial corporate laws
  
- ❖ **Choice of appropriate structure will be based on a number of factors**
  - Whether transaction is “friendly” or “unsolicited”
  - The objectives of the acquiring company
    - 100% ownership or something less
  - Timing concerns

### ADVANTAGES AND DISADVANTAGES OF THE STRUCTURES

#### TAKE-OVER BID

- ❖ **Advantages:**
  - can be used for unsolicited or friendly transaction
  - can be completed in minimum 35 days from mailing (no maximum offer period)
  - can be amended or extended relatively easily if necessary because of competing offer
  - if goal is 50.1% or something less than 100% this is the preferred method
  - can be highly conditional (other than financing)
- ❖ **Disadvantages:**
  - difficult to achieve 100% ownership in one step – will require second stage acquisition
  - must be made to all shareholders on the same terms (all offered the same price)
  - cannot be subject to a financing condition
  - can only acquire those shares tendered
  - beware of collateral benefits

- beware of pre- and post-bid integration

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#### SHAREHOLDER APPROVED

##### ❖ **Advantages:**

- permits acquisition of 100% of shares in one step
- permits flexibility to deal with all classes of securities and possibly to tax structure
- can be subject to conditions including financing condition
- can be court approved (Plan of Arrangement) which provides exemption from U.S. registration pursuant to 3(a)(10) of the 1933 Act
- some flexibility with collateral benefits

##### ❖ **Disadvantages:**

- typically requires approval of at least 66<sup>2/3</sup> % of shares voted at the meeting
- can only be done with co-operation of the Target or its significant shareholders
- takes longer than a take-over (approximately 60 days to call and hold a meeting)
- more difficult to amend

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#### TAKE-OVER BIDS

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#### THE LEGAL REQUIREMENTS?

- ❖ An offer made to at least one shareholder in a Canadian province which would result in the Offeror (and those acting jointly or in concert with it) holding 20% or more of any class of voting or equity securities of the issuer
- ❖ Multilateral Instrument 62-104 – *Take-over Bids and Issuer Bids* effective in all jurisdictions (except Ontario), harmonizes take-over bid rules

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#### EXEMPTIONS FROM THE BID RULES

- ❖ The “**private agreement**” exemption - limited to purchases from five vendors at a price not in excess of 115% of the 20-day average closing price
- ❖ The “**5%**” exemption - purchase of up to 5% of the Target’s outstanding shares in any 12-month period
- ❖ The “**private company**” exemption - purchase of securities of an issuer which is not a reporting issuer and whose securities are not the subject of a “published market”, so long as there are not more than 50 shareholders (exclusive of present and former employees)
- ❖ The “**2%/50**” exemption – shares are owned by fewer than 50 provincial residents and such shares represent less than 2% of the issuer’s outstanding securities of that class (must be UK or US law)
- ❖ The “**foreign take-over bid**” exemption - shares owned by Canadian residents represent less than 10% of the issuer’s outstanding securities of that class and primary market for securities is outside Canada

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#### DISCLOSURE DOCUMENTS

- ❖ A take-over bid circular consists of:

- an offer (a legal offer document containing the terms and conditions on which the offer is made); and
- an offering circular (a disclosure document containing prescribed information concerning the bidder)
- ❖ The take-over bid circular is a liability document
- ❖ Offering documents must provide all material facts concerning the securities of the Target and any matter not generally known, but known to the Offeror, which would reasonably be expected to affect the decision of the Target shareholders to accept or reject the offer
- ❖ Offering documents are not subject to any prior regulatory review by securities commissions
- ❖ French translation of offering documents required for Québec shareholders (unless *de minimis*)
- ❖ If bid consideration includes securities of the Offeror, offering documents must include all material facts concerning such securities

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#### WITHDRAWAL RIGHTS

- ❖ Shareholders have the right to withdraw shares deposited under the bid:
  - at any time within the initial bid period; and
  - within 10 days after a notice of change or variation of the bid
- ❖ However, no new withdrawal rights will arise upon a change or variation of the bid if:
  - the shares have already been taken up;
  - in a cash bid, the variation is only an increase in price and the time period is not extended beyond 10 days; or
  - the variation is a waiver of a condition
- ❖ Withdrawal rights will arise if the Offeror has not paid for the shares within 3 business days after taking them up

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#### IDENTICAL CONSIDERATION AND COLLATERAL BENEFITS

- ❖ All holders of the same class of securities must be offered identical consideration
- ❖ An offeror cannot enter into any agreement with a shareholder that provides such holder consideration of greater value than that offered to other shareholders under the take-over bid

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#### ACCUMULATION OF SHARES PRIOR TO AN OFFER

- ❖ The take-over bid rules apply to certain purchases made by an offeror in the 90 days prior to making a formal take-over bid
- ❖ Referred to as “pre-offer integration” rules
- ❖ Offeror must pay, on the formal offer, at least the highest price paid on any integrated transaction, and offer to purchase the greatest percentage of holdings sold by any vendor in an integrated transaction
- ❖ Rules do not apply to purchases made through a stock exchange

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## TAKING A TOEHOLD POSITION

- ❖ **The reasons for acquiring a toehold are:**
  - to reduce the overall transaction cost (i.e., no premium paid on toehold shares); and
  - to provide a gain on the toehold shares to offset the transaction costs if the Offeror is outbid
- ❖ A significant toehold may also dissuade other bidders
- ❖ Upon becoming an “insider” (10% holder), the Offeror will be subject to more onerous disclosure requirements in preparing its take-over bid circular, including an independent valuation of the Target
- ❖ **Purchaser should be conscious of:**
  - pre-bid integration rules (90 days)
  - early warning system (10% and above), and
  - insider status (10% and above)
- ❖ Any shares acquired prior to the date that the formal take-over bid circular is mailed will not be counted for purposes of:
  - majority-of-the-minority vote in second-step transactions, or
  - determining whether any shares not deposited to the take-over bid can be compulsorily acquired following the bid

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## RESPONSE BY THE TARGET’S DIRECTORS

- ❖ Target board is required to send a directors’ circular to its shareholders within 15 days of the offer
- ❖ Directors’ circular outlines the board’s recommendation to Target shareholders on the offer, must make either positive or negative recommendation or refrain from making one and give reasons
- ❖ The directors of the Target may defer the communication of their final views until seven days before the expiry of the offer
- ❖ Directors are expressly required to disclose any proposed defences to be used against the offer

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## DEFENSIVE TACTICS

- ❖ The defences available to the Target of an unwelcome take-over bid by an Offeror are limited, which is perhaps the principal reason that a very high proportion of Canadian companies which are put “in play” are ultimately the subject of some type of transaction, although not necessarily with the initial Offeror
  - Shareholder Rights Plan (Poison Pill), a “speedbump”
  - White Knight
  - White Squire
  - Crown jewels

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## POST-OFFER TRANSACTIONS

- ❖ If the Offeror is not successful in acquiring 100% of the shares under its bid, the following minority acquisition transactions are available to acquire the outstanding minority holdings:
  - compulsory acquisitions, and
  - going private transactions
- ❖ Both give rise to dissent rights

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## MI 61-101

- ❖ MI 61-101 requires additional procedural and substantive steps to be followed in the context of certain Going Private Transactions (GPTs). If applicable, the most important requirements imposed are:
  - to prepare a valuation of the Target which must be described in the proxy circular relating to the shareholder meeting called to approve the GPT;
  - to obtain “majority of the minority” approval of the shareholders for the GPT; and
  - to provide certain disclosure to shareholders in addition to what would ordinarily be provided in connection with a shareholder meeting or take-over bid circular

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## SHAREHOLDER APPROVED TRANSACTIONS

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### PLANS OF ARRANGEMENT AND AMALGAMATIONS

- ❖ Plans of arrangement and amalgamations are governed by Canada’s federal or provincial corporate statutes, as applicable
- ❖ Canadian corporate statutes do not contemplate forward or reverse mergers. Rather, an amalgamated entity is deemed to succeed to all of the assets and liabilities of its predecessors
- ❖ Court process can become forum for aggrieved stakeholders

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### PLANS OF ARRANGEMENT

- ❖ Plans of arrangement provide broad flexibility in structuring business combinations and provide exemption from the U.S. registration requirement
- ❖ Broad jurisdiction granted to courts. Essentially, apply to court to set process
- ❖ May provide boards of directors greater comfort as fairness of the transaction is assessed by court

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### SHAREHOLDER APPROVAL

- ❖ Fundamental changes under Canadian corporate statutes, including plan of arrangement and amalgamation, typically require two-thirds approval of shareholders voting at the meeting
- ❖ Fundamental changes give rise to dissent or appraisal rights pursuant to which shareholders can elect fair value for their shares

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## PROCEDURE FOR A SHAREHOLDER APPROVED TRANSACTION

- ❖ Set date for meeting of shareholders and record date for identifying shareholders entitled to vote at the meeting
- ❖ Identify all regulatory and third party approvals required
- ❖ Identify shareholders to approach for support
- ❖ Prepare notice of meeting and proxy circular in prescribed form
- ❖ Process for calling and holding shareholders' meeting takes approximately 60 days
- ❖ If a plan of arrangement, obtain preliminary order regarding procedural matters
- ❖ Mail notice of meeting and proxy circular to all shareholders and file with securities regulators
- ❖ Obtain regulatory approvals
- ❖ Hold shareholders' meeting to obtain approval
- ❖ Transaction must be approved by 66<sup>2</sup>/<sub>3</sub>% of those shares voted; class vote if no commonality of interest
- ❖ If plan of arrangement, obtain Court order approving the transaction
- ❖ Satisfy all other conditions to transaction
- ❖ File statutory forms with corporate law regulators to give effect to transaction
- ❖ On filing acquiring company obtains ownership of Target

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### MI 61-101

- ❖ MI 61-101 also requires additional procedural and substantive steps to be followed in a shareholder approved transaction. If applicable, the most important requirements imposed are:
  - to prepare a valuation of the Target which must be described in the proxy circular relating to the shareholder meeting called to approve the transaction;
  - to obtain "majority of the minority" approval of the shareholders for the transaction; and
  - to provide certain disclosure to shareholders in addition to what would ordinarily be provided in connection with a shareholder meeting.

## PRIVATE M&A

### STEPS

- ❖ Commencing the Deal
  - Confidentiality Agreement/NDA
  - Letter of Intent/Term Sheet
  - Due Diligence
- ❖ Regulatory Considerations
  - Competition Act
  - Investment Canada Act
- ❖ Doing the Deal
  - Definitive Agreement
  - Share vs. Asset Purchase Considerations
  - Drafting the Agreement
  - Negotiation Principles and Tactics
- ❖ Closing the Deal
  - Consents and Regulatory Approvals
  - Closing Agendas
  - Closing Documents

### COMMENCING THE DEAL

#### CONFIDENTIALITY AGREEMENT/NON-DISCLOSURE AGREEMENT

- ❖ **Why is it used?**
  - Means by which parties share confidential, proprietary or competitively sensitive information.
  - Restricts the use to evaluating the business solely for the purpose of the proposed transaction.
  - Prohibits disclosure of the confidential information.
  - Typically a one-way agreement unless the buyer is also providing confidential information, in which case a mutual non-disclosure agreement is used.
- ❖ **What does it include?**
  - Defines the “Confidential Information” and may include the potential transactions itself.
  - **Customary exclusions:**
    - Information in the public domain (through no breach of recipient).
    - Information already in the recipient’s possession through lawful means.
    - Information required to be disclosed by court order, arbitration award, or legal process.
  - Defines the permitted use of the Confidential Information - evaluating the business solely for the purposes of the proposed transaction.
  - Restrictions on who recipient can share information with (employees on a need to know basis, professional advisors).



- Return or destruction of documents (electronic and physical destruction, but typically allows copies to remain on servers).
- May include standstill/exclusivity provisions.
- Injunctive relief provisions. – don't care about damages, just need to stop what you're doing.
- Does **not** bind the parties to the deal and does **not** have representations and warranties on the Confidential Information.

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## LETTER OF INTENT/TERM SHEET

### ❖ **What is a letter of intent? What does it include?**

- Once the “deal” is negotiated, it sets out the “intent” of the parties with respect to certain key business terms for the transaction.
- Typically includes standstill/exclusivity provisions, and may include a break fee.
- Does not include the legal terms – states that definitive agreements will be on customary representations, warranties, covenants, indemnities, terms and conditions of a transaction of this nature.
  - What is customary?
- Forms the basis for drafting the definitive deal agreements.
- Binding/non-binding nature
  - Usually a non-binding expression of the purchaser's and/or the seller's interest in the transaction.
  - Generally contains some binding clauses – e.g. exclusivity, expenses, non-solicitation of personnel and customers.
  - Risk of a fully binding letter of intent –becomes the definitive agreement.
- Drafter's dilemma – how much to put in. Once business deal is captured, time is better spent negotiating the definitive deal documents instead of the Letter of Intent.
- Form – Letter of intent (generally delivered by buyer and countersigned by seller) or term sheet (generally negotiated between parties and signed by both).

### ❖ **What happens once the letter of intent/term sheet is signed?**

- Assists the parties and their advisors with structuring the transaction, identifying issues that need to be addressed, commencing due diligence and drafting the definitive agreement and ancillary agreements.
- **Process:**
  - identifies parties to the transaction
  - exclusive dealing (usually includes a termination date to avoid open ended negotiation)
  - good faith negotiations (legal implications of covenant)
  - expenses
  - confirmation of confidentiality agreement
- **Substance:**
  - describes the nature/form of transaction (shares vs. assets)
  - identifies consideration to be paid (cash/shares/mix), adjustments to the consideration and when payment to be made

- may identify whether financing being provided or whether financing needs to be obtained
- may set out key conditions precedent – things that need to be done before closing
- may set out personnel issues – non-competition agreements, resignations, employment agreements
- Although business terms are not binding, can be difficult to move off them unless something comes up in due diligence (part of the good faith obligation).

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## DUE DILIGENCE

### ❖ What is due diligence and why is it done?

- Business/Financial Due Diligence
  - Done by client, investment bankers and accountants to review the quality of the business being acquired (financial statements, taxes, product pipeline)
- Legal Due Diligence
  - Done by the legal team (lawyers, clerks and students) and provides the purchaser with legal information regarding the company, assets or business being acquired and what is required to legally transfer the assets to the purchaser
- *Forms the basis for drafting the representations and warranties made in the definitive agreement (and the schedules attached)*

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## HOW TO CONDUCT DUE DILIGENCE

### ❖ Due Diligence Request List:

- To be sent to the seller or its counsel requesting information and documents relating to the target company.
- Should be a thorough list of all types of documents that the seller/target company may have relating to the business and the company.
- Important to consider the nature of the target company's business and the industry in which it operates to know what to request. Tailor the request list to the particular company and its operations.
- To assist in understanding the business, review public disclosure, newspaper articles, etc.

### ❖ Virtual Data Rooms

- Web-based data room that is set up by the seller team and legal counsel .
- Contains documents that are responsive to due diligence request list.
- Need to obtain guidance from the client on which materials legal counsel is responsible for and which materials the client or other advisors will review.

### ❖ Minute Book Review

- Constating documents and amendments
- Annual filings up-to-date
- Directors and Shareholders minutes/resolutions:
  - Were meetings properly held?
  - Have significant transactions been properly authorized?

- Have share transfers/issuances been properly authorized and recorded in share register?
- Did the Board discuss any significant litigation, regulatory or environmental issues?
- Any Shareholders' agreements, including voting, pooling, transfer or put or call agreements.
- Particulars of the authorized and issued share capital and outstanding debt securities.
- Outstanding convertible securities, options, warrants or pre-emptive rights.
- The names of the shareholders, directors and officers of the Corporation.

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## WHAT TO REVIEW

- ❖ **Corporation's subsidiaries,**
  - If any, including percentage of ownership and any other shareholders.
- ❖ **Jurisdictions**
  - Jurisdictions in which the Corporation is carrying on business or is registered to carry on business.
  - Copies of all registrations or licences to carry on business in each relevant jurisdiction.
- ❖ **Related Party Transactions**
  - Indebtedness of all directors, officers, shareholders and their respective associates and affiliates to the Corporation.
  - Agreements between the Corporation and related parties.
- ❖ **Regulatory Approvals**
  - All licenses, permits, orders, approvals and authorizations of governmental and regulatory bodies.
  - Notices, orders or communications from governmental agencies or other regulatory bodies relating to alleged or actual non-compliance with any regulatory requirements.
  - Reports filed with governmental agencies or other regulatory bodies.
- ❖ **Material Contracts**
  - Are there any clauses which may impact the transaction?
  - Are consents required or does a default occur as a result of the transaction?
  - Are there restrictive covenants?
  - Are the indemnities, guarantees or unusual warranties?
  - Are there most favored nations provisions?
  - Long term (greater than 1-2 years).
  - Governing Law
    - As companies tend to operate in more than one country – the governing law of contracts may not be Canadian and if material may need to be reviewed by legal counsel in a foreign jurisdiction
- ❖ **Intellectual Property**
  - License agreements.
  - Issued (and applications) for patents, copyright, trademark, service marks, domain names.

- Trade names, logos, corporate names, brand names and slogans used in the business.
- Confidentiality and privacy obligations to which the Corporation is bound, or in its favour, including all employee and non-employee invention, confidentiality or non-disclosure agreements.
- Website related agreements and documents, including legal notices and disclaimers.
- Software and system development agreements, support and maintenance agreements, disaster recovery and back-up arrangements, source code escrow agreements, outsourcing agreements and internet and telecommunications contracts.
- Copies of opinions regarding the validity or infringement of third party patents.
- ❖ **Litigation**
  - Particulars of existing or threatened litigation or legal / administrative proceedings.
  - Responses to audit inquiry letters for any legal proceedings still outstanding.
  - Description of all concluded or settled legal proceedings.
  - Particulars of non-compliance (or alleged non-compliance) with applicable laws.
- ❖ **Environmental**
  - Environmental permits, licences, orders, authorizations, notifications or approvals related to the business.
  - Environmental assessments.
  - Buildings used by the Corporation containing PCBs or asbestos.
  - Underground storage tanks.
  - Hazardous or toxic materials used, stored or disposed of in the business.
  - Details of any environmental claims or breaches of environmental laws.
  - Copies of all information filed with any regulatory authority.
- ❖ **Inventory**
  - List of all inventories (including raw materials, work in progress and finished goods), and the age of the inventory.
  - Number of months' supply represented by inventory on hand.
  - Data on obsolete or otherwise unsaleable inventory.
  - Particulars of inventory write-offs over the past three years.
  - Addresses of all warehouse or other facilities in which inventories are located and the value of inventory at each location.
- ❖ **Machinery and Equipment**
  - List all machinery, equipment, computer hardware and software, telecommunication equipment, furniture, fixtures, trucks and automobiles.
  - Particulars of original capital cost, undepreciated capital cost, and depreciation rates.
  - Copies of all equipment purchase and maintenance agreements.
  - Copies of all personal property leases for machinery and equipment.
- ❖ **Real Estate**
  - List of owned real estate:
    - Applicable zoning, outstanding work orders, compliance orders.
    - Registered and unregistered encumbrances and liens.
    - Documents relating to HVAC, electrical systems, mechanical systems, roofing systems, plumbing, etc.

- Maintenance, service and operating contracts.
- Tax Assessments.
- Copies of real property leases:
  - key terms (term, rent, prepaid rent, security deposits, subletting and assigning privileges, guarantees, change of control provisions, options to renew, assignment and sublease).
- Unremedied defaults or breaches of covenants.
- Leasehold improvements.
- ❖ **Insurance**
  - Insurance policies related to the Business, property and assets:
    - scope of coverage, premiums, expiry dates, consents on a change of control, termination.
  - Claims history
- ❖ **Employees & Employee Plans**
  - List of employees:
    - date of hire, position, salary/wages, full/part time, location, benefit plans.
  - Management employees:
    - salary/bonus history, professional credentials, severance arrangements.
  - Written employment and consulting agreements, offer letters, amendments.
  - Employee benefit plans.
    - bonus, pension, stock option, profit-sharing, disability, insurance, deferred compensation
  - Collective bargaining agreements.
  - Contractor/Consulting Agreements (independent salespersons, licensees, representatives and brokers).
  - Personnel policies, procedures and practices.
  - Outstanding / anticipated wrongful dismissal, employment standards, labour relations, occupational health and safety, human rights claims.
  - Pending resignations.
  - Restrictive covenants (non-competition, non-solicitation and confidentiality agreements affecting the Corporation, employees or contractors).
- ❖ **Business matters**
  - List of the largest current customers by revenue.
  - List of the largest current suppliers.
  - Current budget and strategic plans.
  - Operating performance records.
  - Business plans.
  - List of products and services by dollar sales volume and profitability.
  - Product availability lists, catalogues and price lists.
  - Details of product/service complaints and warranty and recall history.
  - Standard form sales contracts, invoices, purchase orders, bills of sale, warranties.
- ❖ **Financial**
  - Financial statements.
  - Current budgets, forecasts, strategic planning proposals.
  - Accounts receivable (aging, details of large overdue accounts).
  - Short and long term indebtedness.

- All loan, financing, guarantee, indemnification, mortgages and security agreements.
- ❖ **Taxes**
  - All jurisdictions where tax returns are filed or sales, value-added, GST, HST are being collected and remitted.
  - Tax returns, tax filings and tax rulings.
  - Notices of assessment or reassessment and all waivers with respect to time limitations.
  - Agreements reached with any relevant taxing authority to settle any disputes.
  - Capital costs and undepreciated capital costs of all classes of depreciable property of the Corporation.
  - Tax elections relating to any reorganizations or dividends.
- ❖ **Anti-Spam**
  - Policies, guidelines and training materials for compliance with *Canadian Anti-Spam Legislation*.
  - Practices in sending electronic messages to persons other than current customers and in use of contact details from purchased lists.
  - Database maintained for compliance regarding consents (dates express consents obtained, purpose for the consents, method of obtaining consents)
  - Status of anti-spam training.
  - Terms of service used by the Corporation (including unsubscribe mechanism).
- ❖ **Public Searches**
  - PPSA, Litigation, Bankruptcy, Bank Act
  - Are there any liens on the assets/shares of the company or the seller?

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#### HOW DO YOU REPORT ON DUE DILIGENCE?

- ❖ Generally a due diligence memorandum is prepared which summarizes the findings and highlights key legal issues
- ❖ Need to obtain guidance from the client as to what is to be included in the due diligence memorandum
  - Summaries of contracts in chart form
  - Summaries in prose
  - List of key legal issues that impact the transaction

#### REGULATORY CONSIDERATIONS

##### COMPETITION ACT

- ❖ Concept of “merger” is broadly defined under the *Competition Act*.
- ❖ All mergers are subject to possible review and challenge, though only those mergers that exceed certain thresholds require pre-merger notification to the Bureau:
  - Substantive test: whether likely to prevent or lessen competition substantially
- ❖ **Commissioner of Competition may challenge a merger at any time up to one year after closing, but parties can obtain comfort by either:**
  - obtaining an advance ruling certificate (“**ARC**”) from the Commissioner, which prevents the Commissioner from later challenging the transaction, or

- obtaining a no-action letter (“**NAL**”) stating that the Commissioner does not intend to challenge the transaction at that time, but retains the right to do so within one year after closing.
- ❖ **At end of review, Commissioner can:**
  - Issue ARC or NAL (or do nothing).
  - Negotiate remedy.
  - Seek order from Competition Tribunal.
- ❖ **Filing is mandatory when thresholds are exceeded.**
  - The applicable thresholds vary based on the type of transaction. For example, the thresholds for a share acquisition (different thresholds for asset acquisition, joint venture, amalgamation and acquisition of interest in non-corporate entity):
    - **Size of Parties Threshold:** the parties to the transaction, together with their affiliates, must have aggregate assets in Canada, or aggregate annual gross revenues from sales in, from, or into Canada, in excess of C\$400 million; and
    - **Size of Transaction Threshold:** the aggregate value of the assets in Canada, or the aggregate annual gross revenue from sales in or from Canada generated from Canadian assets, of the target and its subsidiaries, must be greater than C\$86 million as at February 2015 (amounted subject to annual adjustment)
    - **Equity Threshold:** must be acquiring +20% or +35% of the voting shares of a public or private corporation, respectively, or, where these thresholds have been exceeded but purchaser owns less than a majority of the voting shares, must be acquiring +50% of voting shares
  - Filing fee of \$50,000 (responsibility for payment negotiated between parties).
- ❖ Criminal offence to close without notifying; serious penalties to close without receiving appropriate clearance or waiting period not having expired.
- ❖ **Two filing processes:**
  - Informal process: file a substantive “white paper” where parties explain why the transaction does not raise competition concerns and request an ARC or, in the alternative, a NAL.
  - Formal process: file a notification setting out, among other things, top 20 customers and suppliers by principal category of product, certain class of internal documents prepared or received by an officer or director, and deal documents (parties also will file a white paper with notification).
- ❖ No waiting period associated with informal process. Waiting period applicable to formal process (can be terminated early by Commissioner):
  - 30 days from when parties file their respective notification, unless before end of period Commissioner issues a supplementary information request (SIR).
  - Where SIR issued, 30 days from when parties file a complete response to the SIR.
- ❖ Commissioner’s review can take longer (or shorter) than statutory time frame:
  - Non-complex deal: up to 14 days.
  - Complex deal: up to 45 days (or at end of SIR process).

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## INVESTMENT CANADA ACT

- ❖ The Investment Canada Act (“**ICA**”) applies to the establishment or acquisition of control of a Canadian business by a non-Canadian purchaser.

- ❖ **One of two filings may be required under the ICA**
  - Application for Review
    - Applies only to a direct acquisition of control where monetary threshold is exceeded..
    - 2015 threshold for reviewable transactions under the Investment Canada Act is C\$69 million for investments that benefit from the WTO investor rule.
    - Threshold is based on the book value of assets.
    - Cannot be completed until Minister of Industry has determined that the investment is likely to be of “net benefit to Canada”.
    - Investor will typically negotiate a suitable set of undertakings with Investment Canada in connection with the Minister’s approval.
      - Undertakings are monitored and reviewed by Investment Canada.
    - Initial waiting period 45 days, with a possible extension of 30 days or greater.
    - Political process / consultation with provinces, federal departments and stakeholders.
  - Notification
    - Applies to direct acquisitions of control where monetary threshold is not exceeded, as well as to both indirect acquisitions of control of Canadian businesses and establishment of new Canadian businesses.
    - No substantive review/approval.
    - Filing can be made before closing or within 30 days after closing.
- ❖ **Thresholds under the ICA for review of a direct acquisition of control of a Canadian business:**
  - Control threshold
    - Deemed Control: more than 50% voting shares or voting interests for corporations and non-corporate entities, respectively, or acquisition of all or substantially all of the assets of a Canadian business
    - Deemed Non-Control: less than one-third of voting shares of a corporation or less than a majority of the voting interests of a non-corporate entity
    - Rebuttable Presumption of Control: between one-third and a majority of the voting shares of a corporation
  - Monetary threshold
    - Aggregate (worldwide) assets of C\$354 million or greater (subject to annual adjustment) (subject to revision under CETA)
- ❖ No threshold applicable to indirect acquisitions as only notifiable
- ❖ Special rules apply for cultural businesses and national security

## DOING THE DEAL

### DEFINITIVE AGREEMENT

- ❖ **Share Purchase Agreement (private target)**
  - The shareholders of a privately held company agree to sell their shares to a purchaser
  - Entered into between each of the shareholders of the target company and the purchaser



❖ **Asset Purchase Agreement**

- A company agrees to sell all of its assets to a purchaser
- Entered into between the target company and the purchaser

❖ **Share and Asset Purchase Agreement/Acquisition Agreement**

- A company agrees to sell a business unit to a purchaser (can include a subsidiary, a division, assets or a combination)
- Entered into between the target company and the purchaser

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SHARE VS. ASSET PURCHASE CONSIDERATIONS

❖ **General Rule – Sellers prefer to sell shares and purchasers prefer to purchase assets**

	<b>Share Purchase</b>	<b>Asset Purchase</b>
<b>Pros</b>	<ul style="list-style-type: none"> <li>▪ simplicity of share sale – allows the business to be acquired in a turn-key fashion</li> <li>▪ tend to be fewer third party consents (change of control)</li> <li>▪ capital gain treatment for shareholders (taxed at one level in shareholders’ hands)</li> </ul>	<ul style="list-style-type: none"> <li>▪ one seller, one purchaser</li> <li>▪ can pick and choose which assets are being purchased and which liabilities are being assumed</li> <li>▪ can pick and choose which employees are offered employment (though not always the case in Quebec)</li> <li>▪ potential availability of tax deductions going forward for depreciable assets</li> </ul>
<b>Cons</b>	<ul style="list-style-type: none"> <li>▪ depending on structure, may need to have all shareholders agree and sign the purchase agreement</li> <li>▪ all employees (and employee liabilities) come with the company</li> <li>▪ all assets and liabilities come with the company (known or unknown)</li> </ul>	<ul style="list-style-type: none"> <li>▪ greater potential for business interruption</li> <li>▪ tend to be more third party consents (assignment)</li> <li>▪ taxed at two levels (once in the hands of the corporation and then upon distribution to shareholders)</li> <li>▪ seller is left with a shell company containing only the assets the purchaser didn’t want (and any liabilities that are not assumed)</li> </ul>

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DRAFTING THE DEFINITIVE AGREEMENT

❖ **Price structure:**

- Base purchase price.
- Working capital or other adjustments (debt, cash, expenses, etc.).
- Earn-outs.
- Allocation of purchase price.
- Escrow/holdback.

❖ **Representations and warranties (limiting liability and allocating risk):**

- Fundamental representations (organization, due execution, enforceability, no conflicts, good title).
- Required consents/approvals.
- Financial (financial statements, no undisclosed liabilities, internal controls, receivables).
- Business related (sufficiency of assets, types/quality of assets, intellectual property, material contracts, permits, legal proceedings, compliance with law).
- Other (employment, pensions/benefits, taxes, advisory fees, full disclosure).
- ❖ Representations and warranties insurance.
- ❖ **Covenants:**
  - Regulatory commitment – reasonable efforts/best efforts.
  - Interim period operations of the business.
  - Exclusive dealings/Non-solicitation.
  - Co-operation.
  - Providing updates to representations and warranties.
- ❖ **Conditions of closing (discussed below):**
  - Simultaneous sign and close or bifurcated sign and close.
- ❖ **Indemnification:**
  - Survival periods.
  - Caps and Baskets (threshold vs. deductible).
  - Procedures:
    - Direct Claims, Third Party Claims
    - Who controls?
  - Other Limitations
    - Sandbagging (anti or pro)
    - Insurance and Tax Benefits
    - Sole Recourse
- ❖ **Termination:**
  - Outside date.
  - Breach of representation/warranty that is not curable.
  - Other condition not satisfied/capable of satisfaction.
- ❖ **Boilerplate clauses**
  - Notice.
  - Confidentiality (confidentiality agreement usually terminates on closing).
  - Entire agreement.
  - Assignment.
  - Governing law and attornment.
  - Dispute resolution.
  - **Negotiation Principles and Tactics**

### CLOSING CONDITIONS

- ❖ The definitive agreement is now signed – the closing conditions, if any, specify what needs to be done before the parties are required to close the deal
- ❖ **Types of Closing Conditions**
  - Regulatory Approvals
    - *Investment Canada Act*
    - *Competition Act (Canada)*
    - Other Regulatory Approvals or considerations (examples)
      - Environmental permits
      - First Nation issues
  - Consents of third parties:
    - Assignment (asset deal).
    - Change of control (share deal).
  - Other Common Closing Conditions:
    - Accuracy of representations.
    - Compliance with covenants.
    - No material adverse effect (MAC).
    - No legal challenge/change in law.
    - Release of liens.
    - Amendment/termination of specified agreements.
    - Termination and repayment of credit facilities.
    - Resignation/release of directors/officers.
    - Employment arrangements (hiring/firing).

### CLOSING AGENDAS

- ❖ **Types of Closing Agendas**
  - Simple “checklist/list of steps” style.
  - Detailed “agenda” style.
  - Different forms/types depend on:
    - complexity (size and/or nature) of transaction
    - style of particular lawyer(s)
  - May also contain a deal timeline.
- ❖ **What information is contained in a Closing Agenda?**
  - Standard introductory information/defined terms/parties.
  - Virtual closing / physical closing rules.
  - Escrow agreements and flow of funds (often in a separate document/agreement prepared by the parties).
  - Three (3) main parts:
    - pre-closing
    - closing
    - post-closing
  - Documents, responsibility, delivery, execution, status, due date.

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## CLOSING DOCUMENTS

- ❖ Bring-down certificates.
- ❖ Corporate resolutions and certificates.
- ❖ Ancillary agreements:
  - contractual consents
  - non-competition and non-solicitation agreements
  - employment agreements
  - escrow agreements
  - general conveyance and assumption of liabilities agreements
  - financing payout letters
  - resignations and releases
  - transition services agreement
  - Receipts
- ❖ New Share Certificates & Corporate Minute Book (for a share deal only)
- ❖ Purchase Price Payment