



CANADIAN M&A TRENDS FOR 2012 WORLD'S BEST COUNTRY FOR BUSINESS*

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Is the glass half full or half empty? We are decidedly in favour of the glass being half full, and getting fuller, for Canadian M&A markets in 2012. While uncertainty and slow growth in the U.S. and Europe have affected the Canadian economy, the country has continued, for the most part, to post impressive economic results, thanks not only to unceasing demand for its natural resources but also to its strong regulatory system and stable majority government. Thus – as noted by Canadian Prime Minister Stephen Harper in his year-end address for 2011 – **Forbes recently ranked Canada as the best country in the world in which to do business**, the only country of the 134 surveyed that reached the top 20 in ten separate metrics. All things considered, therefore, we expect favourable growth in M&A activity in Canada in 2012.

The following are some of the top “trending topics” for the coming year:

1 | Tax Trends (and a New Twist on Income Trusts?)

Rumours of the demise of the **income trust** may have been exaggerated, which is positive news for M&A participants looking for “made in Canada” liquidity alternatives. By way of background, in 2006 (on Halloween night), the Department of Finance unexpectedly announced proposed changes to Canadian tax rules under which tax would be imposed on publicly-traded trusts and partnerships, just as it is imposed on Canadian corporations. While these “SIFT Rules” did not become fully effective until January 1, 2011 (and do not affect REITs), the 2006 announcement largely signaled the end of business and resource income trusts, entities that had effectively been treated for tax purposes as flow-through vehicles not subject to taxation.¹ However, the SIFT rules do not apply to foreign source income, and in 2011 we began to see a few income trust offerings in Canada in which investors were given exposure to U.S. resource-based assets and foreign real estate assets through the income trust structure. **Look for this trend to continue in 2012, with offerings providing Canadian yield-seeking investors with exposure to other foreign-based asset classes, such as real estate.**

U.S. buyers in cross-border M&A transactions into Canada will continue to utilize creative acquisition structures, including the **continued use of Luxcos and ULCs**, although proposed changes to the Canada-Barbados treaty will likely make **structures using Barbados entities to invest in Canadian real estate companies less effective, with the result that they may need to be unwound or restructured before January 1, 2013.**

¹ Needless to say, this characteristic made them very popular with Canadian tax-exempts, non-residents and even Canadian taxpayers who could earn business income through a public vehicle on a more tax-efficient basis than income earned through a public corporation.

*Badenhausen, Kurt, “The Best Countries for Business”, *Forbes.com LLC™*, November 3, 2011, referring to Canada as ranking No. 1 in Forbes’ annual look at the Best Countries for Business.

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2 | Competition and Foreign Investment Regulation

Canada’s antitrust regulator, the Competition Bureau, continues to aggressively assert itself on a number of important fronts. High-profile, ongoing M&A matters include an application to block Air Canada’s proposed joint venture with United Continental, the investigation of the Maple/TMX transaction, and an application to dissolve a completed transaction that was not large enough to trigger a pre-closing notification requirement. Many observers trace **the more vigorous enforcement of Canada’s competition laws** to 2009 amendments giving the Bureau enhanced information-gathering powers and **longer periods of time to investigate mergers, and greater penalties for anti-competitive conduct. We expect this trend to continue in 2012.** The Bureau also released new Merger Enforcement Guidelines in 2011 (following a similar update to the U.S. guidelines in 2010) in an attempt to preclude bidders in hostile bid transactions from using disclosures as a tactical weapon.

From a foreign investment law perspective, 2011 proved surprisingly uneventful for a year born in the shadow of the Minister of Industry’s rejection, in late 2010, of BHP Billiton’s hostile bid for Potash Corporation of Saskatchewan. Greater guidance on the scope and meaning of the “net benefit to Canada” test contained in the *Investment Canada Act* (ICA) had been anticipated in the wake of the Potash decision, but ultimately no such guidance was forthcoming. It appears, instead, that the **federal government is adopting a “case-by-case” approach to high-profile matters under the ICA.** Had it proceeded, the proposed acquisition by London Stock Exchange plc of TMX Group Inc. may have proved another challenge under the ICA. We do not expect any material legislative changes to occur in 2012 in

relation to the ICA, but there may be important developments in terms of potential changes to foreign investment restrictions in the telecom sector - a very hot topic in recent years.

The annual change (based on cost-of-living) to the review threshold under the ICA for direct acquisitions by WTO investors in non-cultural businesses is anticipated to be \$330 million for 2012 (book value of target assets). Regulations first proposed in 2009 that would have amended the calculation of thresholds under the ICA based on an “enterprise value” concept have not yet been implemented and the current thinking is that they may be discarded altogether.

It is also worth noting that U.S. Steel Corp. recently reached an out-of-court settlement with the Canadian Government with respect to allegations that the company had failed to abide by various undertakings provided under the ICA to gain approval of its acquisition of Stelco, the Canadian steelmaker. U.S. Steel's defence basically relied on the unexpected economic downturn as justification for not honouring undertakings involving maintaining steady employment and continued steel production of two plants. In light of this settlement, watch for **heightened scrutiny and enforcement by the federal government of undertakings provided under the ICA.**

3 | Poison Pills

For many years, the view of the Canadian securities regulators on shareholder rights plans (commonly referred to as “poison pills”) was that poison pills were strictly limited to the single purpose of helping the board “buy time” to seek out improved or alternative offers. As a result, in contrast to U.S. practice, poison pills could not be used by a board of directors in Canada as part of a “just say no” defence.

Over the past few years, a series of developments suggested that securities regulators were becoming more flexible in assessing the allowable purposes of poison pills, and that the conventional view that “eventually a pill must go” may be an overstatement, at least where securityholders had given a strong and recent endorsement to the pill or where a bid appeared to be an opportunistic attempt to wrest away control of the company during a difficult economic period.

Although rulings in 2010 and 2011 reversed this trend by reaffirming the traditional view of poison pills, the appropriate role of poison pills as a defensive measure continues to be debated by regulators and market participants. In late 2011, at a public roundtable discussion, the OSC revealed that it is currently reconsidering **its historical approach to shareholder rights plans. New proposals being considered include allowing shareholder rights plans to remain outstanding if approved by shareholders, subject to the ongoing rights of shareholders to remove the plan on a “majority of the minority” vote** (requiring a bidder to launch a proxy battle or proceed with a permitted bid). The purpose of the rule would be to provide more consistency and certainty in the context of defensive tactics and decrease the need for regulatory intervention. **The progress of this proposal will almost certainly be among the most closely-watched developments in Canadian M&A in 2012.**

4 | Canadian Financial Markets in Support of M&A

2011 saw the re-emergence of a more established **domestic high yield debt market** in Canada with yields rising and the Canadian market re-pricing itself in the second half of the year. Cara Operations Ltd. accessed the Canadian high yield market for acquisition financing in respect of Prime Restaurants Inc., which was arguably the first time a Canadian issuer had accessed the Canadian high yield market where proceeds were earmarked solely for acquisition financing (which transaction was ultimately not completed). While this market continues to develop with several Canadian dealers adding domestic market expertise and/or U.S. sourcing capability, **larger Canadian issuers continued to access the U.S. high yield market for larger amounts of capital (i.e. above \$500M), a trend which we expect to continue in 2012.** On the leveraged buyout side, the **mid-market remained robust in Canada in 2011 and we expect to see this segment remain active in 2012.** The fourth quarter of 2011 also saw some very large leveraged buyout transactions in the United States which bodes well for the higher end of the market in Canada, which transactions we have not seen domestically for several years. With the depth of the Canadian debt markets continuing to increase, we also expect to see **more specialty lenders in 2012** (which we have not seen on transactions over the last few years) with several new bridge, subordinated debt, mezzanine and niche and industry-focused lenders participating in the Canadian capital markets, many of which are active in structuring hybrid transactions with both debt and equity components to both private and public issuers.

In addition, in 2011 there were an increasing number of **re-leveraging transactions.** These transactions involved deals primarily completed in 2006-2008 whereby the financial sponsors had tried to sell their investments and take their money off the table, but were unable to find a purchaser at an acceptable price. We expect to see more re-leveraging of portfolio companies in 2012 to permit these sponsors to effect liquidity and sell their equity. We also expect to see a **refinancing bulge over the next 2-3 years** as there are many 2005 – 2007 acquisitions which are becoming due for re-financing, potentially limiting the availability of funds for new deals.

5 | Continued Appetite for Canadian Natural Resources

2012 will most certainly experience **continuing global demand by foreign investors for Canadian natural resources, especially from India, China, Korea, Japan and other Asian-based investors.** In addition to going-private transactions in the form of tender offers or plans of arrangement, this sector continues to see more creative and strategically oriented investment structures. De facto control transactions involving **private investment in public entities (PIPES)** for equity investments of more than 20%, together with negotiated investors' rights or similar agreements (with board representation, veto rights over certain corporate transactions and pre-emptive rights) **are expected to remain prevalent.** In addition, transactions **involving alternative structures in the natural resource sector in the form of non-control or “toe hold” equity investments below 20%,**

coupled with secured lending facilities and exclusive off-take agreements, are expected to continue to aid the demand in 2012 for certain commodities, including copper and base metals. Several examples of this occurred in the Canadian marketplace in 2011, including Korea Resources Corporation's \$400 million investment in Capstone Mining Corp. through which it acquired just under 20% of Capstone and permitted Capstone to purchase for \$700 million Far West Mining Ltd., a Canadian copper exploration company with copper assets in Chile, and was coupled with a joint venture and off-take agreement which provided rights to Korea Resources to sell a minimum number of tonnes of copper.

6 | Earnouts

We anticipate that the Canadian economy and M&A markets in Canada will continue to grow incrementally in 2012, with market uncertainty resulting in many real or perceived value differences between buyers and sellers of businesses, as well as continued difficulty in many circumstances to find acquisition financing – particularly for highly-leveraged transactions. To bridge gaps on valuation and/or financing we anticipate the continued use of earnouts, seller-financing (vendor-take backs or VTBs), seller rollover equity and the seller receiving buyer stock (perhaps with “puts” and/or “calls”).

The more interesting developments that we anticipate in 2012 include:

- **Earnouts being structured through a preferred share mechanism** (instead of a pure contractual obligation). This raises additional issues including compliance with corporate solvency restrictions (which may necessitate a third party guarantee) and will potentially require a shareholders agreement. This also brings into play, in favour of the seller-shareholder, oppression and other corporate remedies.
- **Structured equity**, whereby the seller receives common equity which provides a deferred payout tied to a hurdle rate of return - if buyer achieves such target over a period of three to five years the seller participates in an agreed portion of the upside.
- **Contingent value rights (“CVRs”)** which are a form of transferable, earn-out security sometimes used as partial acquisition currency in the purchase of a public company. CVRs are usually tied to a specific milestone (such as the issue of a patent or receipt of regulatory approvals that allow the sale of a new product) but have been used, for example, to guarantee the value of buyer's stock for a period after closing.

7 | Reverse Break Fees

We expect that reverse break fees (paid by the purchaser in the event that it breaches or cannot complete a proposed transaction in specified circumstances) will become more prevalent in Canadian M&A transactions in 2012. Unlike the first generation of reverse break fees several years ago – which were designed primarily to compensate target companies in public M&A transactions who were being acquired by financial buyers in the event a regulatory or financing condition was not satisfied – reverse break fees are now more commonly used in public and, to a lesser extent,

private change of control transactions and with both strategic and financial buyers. In addition, they now address a broader range of deal risks for target companies.

U.S. practice has had a major influence on reverse break fees in Canada. As a result, Canadian reverse break fees have ceased to be equal or symmetrical to the break fee amounts typically received by a buyer. Instead, they are often higher in value (and in many instances substantially higher) in recognition of their distinct underlying economic purpose, although reverse break fee percentages are still generally in the single digits, not approaching the 20% reported in the case of the Google-Motorola deal in the U.S. **We expect to see continued use of reverse break fees in Canada, particularly where buyers are able to negotiate for the reverse break fee being the exclusive remedy available to the target company, therefore allowing a buyer to limit its liability exposure.** In addition, reverse break fees are now a common feature of share-for-share acquisitions given the recent changes to the TSX rules whereby listed companies must obtain shareholder approval in order to issue more than 25% of their outstanding shares in connection with an acquisition or another public company.

8 | Continuing Influence of U.S. M&A and Private Equity Practice

The influence of U.S. M&A and Private Equity practices in Canada, through cross-border transactions, will continue unabated in 2012:

- **Limits or caps on indemnity claims continue to decrease**, with many transactions having caps in the range of 5 to 15% of deal value (with lower levels in a robust auction context).
- With such decreasing caps comes an **increase in the number of exceptions to caps** – “fundamental” warranties have now been extended in many transactions to employee and benefit plan matters, tax matters, environmental matters, and even related-party transactions and arrangements.
- **Increased use of a “materiality scrape”** whereby all materiality qualifications (including MAE) to representations and warranties are removed for purposes of the closing condition and is now being applied for purposes of damage claims – thereby making the deductible the materiality threshold (better known as avoiding double materiality).
- Expect **further battles between buyer's request for “sandbagging” provisions** (a buyer can seek indemnification for breach of warranties notwithstanding knowledge of such breach) and seller-friendly anti-sandbagging provisions. Buyers with sandbagging provisions continue to resist warranties to the effect that they hold no knowledge of breach (which would have provided a basis for a counterclaim in appropriate circumstances).
- **Escrows (as opposed to holdbacks) continue to be very popular**, particularly with private equity participants, as a source of payment for indemnification claims; often being the sole and exclusive source of indemnification claims in auction contexts. Often the amount and duration of such escrow fund matches the cap and general survival period for warranties.

- **General survival periods for warranties continue to decrease.** A typical general period might be the lesser of 18 months from closing and three months following the end of the next fiscal year following closing. Common exceptions from such general survivorship periods include “fundamental warranties” (such as title to shares) and taxes (though even these exceptions are often negotiated in robust auction contexts).

9 | Controlled Auctions

As the M&A market continues to improve, we anticipate that controlled auctions will remain a preferred route for many sellers. Because controlled auction transactions have been a major bright spot in the post-2008 Canadian marketplace, particularly in the mid-market, U.S. firms looking for acquisitions north of the border will generally want to remain open to such a transaction as a means of entry into Canada. **In its broad outlines, a controlled auction is similar in Canada and the U.S., but as always the devil is in the detail.** In advising U.S. companies and their counsel, we continue to stress a number of key points about Canadian law and practice in this area. For example, the Supreme Court of Canada’s 2008 *BCE v. 1976 Debentureholders* ruling established that **Canada does not recognize a strict “Revlon” duty to maximize shareholder value in the context of change-of-control transactions.** Instead, a director’s fiduciary duty is defined with respect to longer-term interests of the company and can include consideration of the interests of non-shareholder stakeholders (e.g. creditors or employees).

With respect to the procedural aspects of controlled auctions, there is no reason to expect any change to **Canada’s tradition of judicial deference to seller-established auction rules.** As technology continues to improve and gain acceptance, we expect to see **continued growth in the use of electronic data rooms and a continuation of the corresponding decline in the use (and/or length) of confidential information memoranda.** On the regulatory front, 2012 is anticipated to be “more of the same”: as always, there can be foreign investment review issues for foreign entrants into Canada in the context of a controlled auction, particularly in regulated industries such as transportation, communications and financial services. Regulatory risk in the antitrust area is similar to what might be experienced in the U.S. and can sometimes be alleviated in an auction context if a prospective purchaser obtains confidential pre-transaction guidance from Canada’s Competition Bureau. It also generally continues to be the case **that partnering is permitted in Canadian controlled auctions only with the consent of the target, with a diminishing chance of such consent as the process progresses.**

Finally, since Canada’s recent abolition of withholding tax on interest payments to foreign lenders, we are seeing **more private equity and other financial buyers rely on their U.S.-relationship banks for committed financing (often without commitment fees) at early stages of auction processes when success is still uncertain.** This is often advisable because Canadian acquisition financing markets are generally more limited than their U.S. counterparts.

For further information on controlled auctions in Canada, see our recent paper “Controlled Auctions in Canada: Tactical and Strategic Legal Considerations”, at <http://www.canadiansecuritieslaw.com/2011/11/articles/mergers-acquisitions/controlled-auctions-in-canada-tactical-and-strategic-legal-considerations/>

10 | Quebec’s “Plan Nord”

In 2011, the government of Quebec announced the “Plan Nord”, a major economic development project for the vast northern region of the province. Plan Nord is expected to lead to investments of \$80 billion over the next 25 years in the natural resources and infrastructure sectors. Plan Nord accordingly represents an attractive investment opportunity for foreign investors, especially from rapidly modernizing countries such as China and India, in light of an increasing demand for resources and commodities around the world. In 2012, we expect to see growth in acquisitions, joint ventures and financing activities pertaining to mining, transportation, energy and infrastructure projects in this region.

11 | Distressed M&A

With the continued global recession, Canadian **insolvency filings in 2012 are expected to remain relatively similar to 2011 but could spike if the economy slows and exposed businesses** – in particular those dependent on exports, given the relative strength of the Canadian dollar, or discretionary consumer spending, given the current levels of Canadian household debt – seek protection under Canadian insolvency laws. Certain 2009 amendments to the *Companies’ Creditors Arrangement Act* (CCAA) and the *Bankruptcy and Insolvency Act* (BIA) have narrowed the differences between Canadian legislation and its U.S. equivalent. One important result is that sales of assets in distressed companies with strong presences in both Canada and the U.S. have become more efficient and the reorganization process speedier and more efficient. Of particular note in larger insolvency proceedings in which a sale of the debtor’s assets is contemplated, the “stalking horse” approach is becoming firmly entrenched as the method of choice for maximizing value. In addition, recent affirmation by courts of the legitimacy of credit bidding has emboldened purchasers with “loan to own” strategies and secured the favorable position held by senior lenders in the reorganization process.

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