

Another record year for M&A

William J Braithwaite and John J Ciardullo of Stikeman Elliott assess Canada's year

The past year was a record one for Canadian mergers and acquisitions, with transaction volumes soaring to all time highs. However, the second half of 2007 was marred by the North American credit crunch, and transaction volumes suffered as a result. According to data compiled by *Financial Post Crosbie: Mergers and Acquisitions in Canada*, there was \$370 billion worth of deals in 2007, up a staggering 44% over the record \$257 billion of deals in 2006. But there were fewer transactions in the second half of the year and leveraged buyouts over \$100 million involving financial buyers fell dramatically from 78 (\$85 billion) in the first half of 2007 to 13 (\$10.7 billion) in the second.

Most M&A practitioners expect reduced volumes and fewer leveraged buyouts in 2008 as the market continues to digest the large backlog of debt in the pipeline. Members of the M&A bar are hopeful that activity will remain respectable by historical standards as a result of transactions involving strategic buyers (including non-Canadian buyers), sovereign wealth funds and the continued presence of financial buyers in transactions where leverage is less of a factor, and due to continuing economic drivers such as strong balance sheets, the trend towards globalisation and the competitive landscape in North America.

Transactions of note (announced or completed) in 2007 included:

- The \$50.7 billion acquisition of BCE by a consortium including the Ontario Teachers' Pension Plan, Madison Dearborn Partners and Providence Equity Partners.
- The \$38.1 billion acquisition of Alcan by Rio Tinto Group, following an unsolicited bid for Alcan by Alcoa.
- The \$17.6 billion merger of Reuters Group and Thomson Corp.
- The \$8.7 billion buyout of the minority shareholders of Shell Canada by Royal Dutch Shell.
- The \$5 billion acquisition of PrimeWest Energy Trust by Abu Dhabi National Energy Company PJSC.
- The \$3.8 billion acquisition of Four Seasons Hotels by Kingdom Hotels International, Cascade Investment and Triples Holdings.
- The \$1.85 billion acquisition of Algoma Steel by Essar Global.

Topics of interest

Disclosure of transaction negotiations

In February 2007, the Ontario Securities Commission commenced a regulatory proceeding against AiT Advanced Information Technologies Corp and certain of its directors alleging that pre-agreement M&A discussions had ripened to the point of constituting a material change in the business and affairs of AiT, the Canadian securities law standard for transaction disclosure.

The charges caused considerable uncertainty among members of the M&A bar. They suggested that the regulators' view of the law was inconsistent with the longstanding general practice of disclosing M&A transactions at the point of entry into a definitive agreement in respect of the transaction (absent unusual circumstances or leaks), and suggested that disclosure could be required at a much earlier stage (for example, perhaps even as early as the non-binding letter of intent stage).

Almost a year later, the Canadian M&A bar is breathing a sigh of relief. The decision of the Ontario Securities Commission tribunal has essentially sanctioned pre-AiT market practice by retaining a high standard for transaction disclosure, and indicating that sufficient evidence of a commitment to do a deal, and that the deal will get done, must exist before a material change has occurred, and that where material conditions exist, as in the case of non-binding letters of intent, transaction discussions will generally not be disclosable.

Ability of buyers to restrict the target board

In the 2007 case of *Ventas REIT v Sunrise REIT*, the Ontario Court of Appeal had occasion to consider the circumstances when and the extent to which a target board can contract out of its fiduciary duties.

In late 2006, Sunrise began an auction process, two of the participants in which were

Ventas and Health Care Property Investors (HCP). As part of the process, HCP signed a confidentiality agreement containing an 18-month standstill with no spring that was triggered upon a third party transaction surfacing. Sunrise eventually accepted a \$15 per unit bid by Ventas. The parties entered into a merger agreement that, among other things, required Sunrise to enforce all existing standstill agreements. After the announcement of the transaction, HCP surfaced publicly with an offer of \$18 per unit. A claim by Ventas ensued, seeking an order that Sunrise enforce the standstill provision as required by the merger agreement.

The most interesting aspect of the Court of Appeal decision was how it responded to the position of HCP, the gist of which was that the Sunrise Board could not contract out of its fiduciary duties. The Court of Appeal responded to this argument by holding that:

"[t]he trustees did not contract away their fiduciary obligations. Rather, they complied with them by setting up an auction process... that was designed to maximize the unit price obtained for Sunrise's assets, in a fashion resembling a "shotgun clause", by requiring bidders to come up with their best price in the second round, subject to a fiduciary out clause that allowed them to consider superior offers from anyone save only those who had bound themselves by a Standstill Agreement in the action process not to make such a bid".

The Court of Appeal further applied the business judgement rule. It held that the trustees' judgment in maximising value in a change of control transaction was entitled to deference because they had established a process based on professional advice, which led to a premium offer from Ventas.

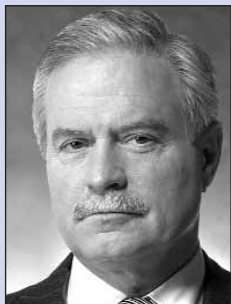
Following the Sunrise decision, there has been considerable chatter among members of the Canadian M&A bar concerning how far one can go in applying the principle from the case. Clearly there is no blueprint for a successful process. A board has considerable latitude in conducting a process and selecting a transaction partner, particularly in economic times where financing is less available, auction processes are less robust and boards have mechanisms such as go-shops to utilise in response to pre-emptive bids.

Foreign buyers

Non-Canadian strategic buyers, including BRIC buyers, featured prominently in many

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Author biographies



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significant competitive bidding situations in 2007, usually beating out any North American bidder or bidders in the process. Given the limitations associated with its paper, the non-Canadian bidder offered all cash, and in a contest between a North American strategic bidder's paper and a foreign bidder's cash, the market took cash. Examples of such deals include Russia's Norilsk Nickel bidding \$6.8 billion for Canadian Lion Ore to top Xstrata's \$4.6 billion bid, Sweden's SSAB's \$7.7 billion acquisition of IPSCO and Rio Tinto's successful \$38.1 billion bid for Alcan to top a \$33 billion offer by Alcoa.

Despite lingering concerns about the so-called hollowing out of corporate Canada, it is not expected that the federal government

will impose serious impediments to prevent sovereign funds or other foreign buyers continuing as key buyers (see discussion below regarding recent Investment Canada Act developments). Accordingly, the group is expected to figure prominently in the 2008 Canadian M&A scene.

What's next for private equity?

In our year in review submission in respect of 2006, we reported on the marked increase in the participation of private equity firms (particularly from the US) in the Canadian M&A environment and upon some of the deal terms common to such transactions.

Notable transactions in 2007 included:

- The \$2.3 billion acquisition of Alliance

Atlantis Communications by a consortium including Goldman Sachs Capital Partners.

- The \$3.5 billion acquisition of CCS Income Trust by a consortium of private equity buyers including CAI Capital Partners.
- The \$7.75 billion acquisition of Thomson learning assets by a consortium including OMERS and Apax Partners.
- The \$51.7 billion acquisition of BCE.

However, M&A activity involving private equity firms has been dramatically reduced as a result of the North American credit crunch and the end of so-called covenant-lite financing. In addition, there are numerous examples of transactions in the US where private equity firms have attempted to exercise MAC outs, re-cut deals or paid reverse break fees or a settlement amount less than the full amount of the break fee to exit transactions.

A hot topic of conversation among members of the Canadian M&A bar is what will be next in the evolution of private equity deal terms when (as is expected) the market that is conducive for such transactions returns. At a minimum, we expect there to be considerable tension between private equity firms looking to preserve a financing out and target companies pushing back on such provisions (or at least for higher break fees) in light of evidence that private equity firms may walk or tend to view reverse break fee provisions as an option. In addition, greater attention will no doubt be paid to contractual provisions such as MAC clauses, remedies for breach and conditions to closing, as well as lenders' funding conditions.

National harmony

Through rule changes that became effective on February 1 2008, Canadian securities regulators introduced a new regime designed to harmonise and streamline the requirements applicable to Canadian take-over bids.

While the regimes still consist of separate rules in Ontario and all jurisdictions other than Ontario, they result in similar or identical requirements across the country. Harmonised guidance will also be issued concerning the manner in which the two regimes are to be interpreted and applied.

In conjunction with the implementation of the new take-over bid regimes, the Ontario and Quebec regulators have implemented (also effective February 1 2008) a joint rule imposing additional requirements on certain transactions such as insider bids, going-private (business combination) transactions, related-party transactions and issuer bids, which replaces separate regimes that existed in these jurisdictions.

The new regime is principally a harmonising/consolidation effort, but it also codifies certain historical discretionary exemptions and contains some substantive changes.

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Takeover methods

M&A transactions involving Canadian public targets typically take one of two principal forms.

Takeover bid

A takeover bid is an offer to acquire 20% or more (including the securities currently owned or over which control or direction is exercised by the bidder or any joint actors) of the outstanding voting or equity securities of a target company made directly to shareholders of the target. Advantages to a bidder of proceeding by way of takeover bid include its potential timing advantages (takeover bids must remain open for a minimum of 35 calendar days and a statutory compulsory acquisition procedure is available if 90% of the shares subject to the bid, other than the bidder's shares, are tendered) and the degree of control it provides the bidder. Takeover bids are also the principal (and only realistic) means by which an acquirer will seek to acquire control of a target company on an unsolicited basis.

Plan of arrangement

Plans of arrangement are a one-step negotiated form of transaction whereby all aspects of the transaction are court supervised and approved. The plan of arrangement structure is extremely flexible and can be used to facilitate a myriad of different transaction forms, as well as other activities such as reorganisations for reasons often related to obtaining a bump for tax purposes and the termination of stock options in consideration for cash or securities. US acquirors often utilise the arrangement procedure, since it provides an exemption from US registration requirements in transactions that involve the issuance of US paper. Boards of directors also like this form of transaction because it is perceived to add a layer of independent review and approval. Negative aspects of the statutory arrangement procedure include the time involved to obtain the requisite court and shareholder approvals and the fact that the court process and required shareholder meeting provide a forum to oppose the transaction.

Thresholds and other considerations

Any person who acquires beneficial ownership of, or the power to exercise control or direction over, 10% or more of any class of voting or equity securities of a target company must promptly issue a press release to that effect and within two business days make a public filing with the applicable securities regulators. Similar disclosure must be made in respect of each additional 2% interest acquired, and a trading moratorium is imposed for one business day following the date on which the report is filed. If a takeover bid for the target's securities is already outstanding, the disclosure threshold is lowered from 10% to 5%. Both the press release and the public filing must

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contain prescribed information, including the identity of the bidder and its intentions in purchasing the shares.

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Competition and anti-trust

The Commissioner of Competition, who is the head of the Competition Bureau, enforces and administers the Competition Act (Canada). The Competition Act establishes a regime for compulsory pre-merger notification of certain acquisitions and business combinations that exceed specified monetary and shareholding thresholds (where applicable). Pre-merger notification triggers a mandatory waiting period that must expire, or be terminated or waived before closing may occur.

The pre-merger notification provisions of the Competition Act apply to several types of transactions, namely acquisitions of assets or shares, business combinations and the formation of, or acquisition of interests in, unincorporated business combinations. A pre-condition to notification, however, is that the target of the acquisition must own or control an operating business in Canada. Certain exemptions also apply.

Determination of whether a transaction exceeds the thresholds for pre-merger notification under the Act depends on the specific structure of a given transaction. Generally, though, a proposed transaction is notifiable if it exceeds:

- The size of parties threshold: the book value of assets in Canada or gross revenues in, from or into Canada of all of the parties, together with their affiliates, of greater than C\$400 million.
- The size of transaction threshold: generally C\$50 million (C\$70 million for combinations) based on the book value of the assets in Canada being acquired or the Canadian assets of the entity the shares of which are being acquired, or gross revenues from sales in or from Canada, generated by those assets.
- In the case of share acquisitions, an additional shareholding threshold must be exceeded. As a result of the transaction,

the purchaser and its affiliates must hold more than 20% of the voting securities of a public corporation or more than 35% of the voting securities of a private corporation. If these ownership levels are already exceeded, the purchaser is required to file if its ownership of voting securities of a public or private corporation exceeds 50% as a result of the transaction.

It is noteworthy that even when a transaction does not trigger a mandatory pre-merger notification filing, it remains subject to the substantive merger review provisions of the Competition Act for a period of three years following closing.

Policy developments

One of the most significant competition law developments in 2007 was the Competition Tribunal's landmark decision in the Labatt-Lakeport merger case. In that case, the Bureau had sought an extension and interim order from the Tribunal preventing Labatt Brewing Company from completing its acquisition of Lakeport Brewing Income Fund for 30 days after the completion of the 42 calendar day no-close waiting period. On March 28 2007, the Tribunal denied the Bureau's request, finding that the Commissioner had not met the burden of establishing that closing the transaction would substantially impair the ability to remedy a substantial lessening of competition. The decision makes it clear that if the Bureau refuses to negotiate or accept a hold separate before the closing of a transaction and seeks an injunction preventing the merger, the Tribunal will closely examine the Bureau's approach in determining whether it is reasonable to delay the closing pending completion of the Bureau's review. The decision is significant as it may now be possible to close complex transactions earlier than was previously thought, as the Commissioner may be held to the statutory waiting period in cases where she is unable to show that there is no effective post-closing remedy. On January 22 2008, the Federal Court of Appeal dismissed the Bureau's appeal of the Tribunal's decision.

Investment Canada Act

The Investment Canada Act (ICA) applies to any “acquisition of control” by a “non-Canadian” (that is, by a purchaser the ultimate

control of which resides outside of Canada) of a “Canadian Business” (that is, a business carried on in Canada that has a place of business in Canada, or an individual or individuals in Canada employed or self-employed in connection with the business and assets in Canada used in carrying on the business). When these criteria are met, a proposed transaction triggers an obligation to file either a notification or an application for review regardless of whether the Canadian-based business is Canadian-controlled.

A notification is essentially an administrative formality, constituting notice of the investment (with certain required information in respect of the investment) to be filed within 30 days of closing. A review application, on the other hand, is more onerous. It generally constitutes a bar to closing until receipt of requisite approval(s) under the ICA. Investments are only reviewable, however, when certain thresholds are met.

Assuming a purchaser is a “WTO Investor” (that is, ultimately controlled by WTO nationals) within the meaning of the ICA, a review application is required for direct acquisitions if the value of the assets (as set out in the financial statements for the most recently completed fiscal year) of the Canadian business(es), and all other entities in Canada the control of which is being acquired (during 2008), equals or exceeds C\$295 million (this asset threshold is indexed every January 1). Indirect acquisitions (that is, the acquisition of a Canadian business as a result of the acquisition of a corporation outside Canada that controls an entity in

Canada carrying on the Canadian business) are typically exempt from review if either the purchaser or the vendor is WTO-controlled.

It should be noted that the C\$295 million threshold in respect of direct acquisitions is reduced to only C\$5 million, and indirect acquisitions are reviewable, when the value of the assets (as set out in the financial statements for the most recently completed fiscal year) of the Canadian business(es), and all other entities in Canada the control of which is being acquired, equals or exceeds C\$50 million, in respect of investments in certain sensitive industries including uranium production, financial services, transportation services and cultural industries.

In recent years, the ICA process has received greater attention. There has been an increasing concern, in certain circles, regarding the alleged “hollowing out” of corporate Canada. This has led to more extensive, rigorous and sometimes lengthier binding undertakings being demanded as a condition to clearing a transaction under the ICA process.

Recent developments

The public debate in Canada over the hollowing out of corporate Canada through foreign takeovers continued through 2007. In July, the federal government struck a task force, the Competition Policy Review Panel, to report back in 12 months on whether changes should be made to the ICA, amongst other subjects. In December 2007, the Minister of Industry issued guidelines concerning investments by state-owned enterprises (SOEs). The guidelines indicate

that where a transaction is already reviewable under the ICA, the government will examine the corporate governance of the SOE investor as well as whether the Canadian business being acquired will continue to operate on a commercial basis. It is likely that to the extent that an SOE buyer is perceived to look and act like a private sector entity with an arms’ length relationship with its home state, the Canadian government will not have a high level of concern arising from its state-owned status. In spite of public debate concerning acquisitions by foreign SOEs, the \$5 billion acquisition by state-controlled Abu Dhabi National Energy (better known as Taqa) of PrimeWest Energy Trust received Investment Canada approval within the normal review period (although it occurred before the release of the SOE guidelines) and it is anticipated that the federal government will not in impose serious impediments to prevent sovereign funds or other foreign buyers continuing as key acquirors. At the same time, the acquisition of high-profile Canadian companies in key sectors of the economy would almost certainly be subject to intensive scrutiny and potentially substantial commitments to the Canadian government.

In 2007, the federal government also announced its intention to consider the adoption of a national security test for foreign takeovers of Canadian businesses – an issue that the ICA does not currently address. It is expected that such a test would be introduced through an amendment to the ICA, but no draft legislation has been put forward at this time.