Private Equity

Contributing editor
Bill Curbow

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Simpson Thacher & Bartlett LLP

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CONTENTS

Global overview 7
Bill Curbow, Atif Azher, Peter Gilman, Fred de Albuquerque and Audra Cohen
Simpson Thacher & Bartlett LLP

Fund Formation

Australia 10
Adam Laura, Deborah Johns and Muhunthan Kanagaratnam
Gilbert + Tobin

Austria 17
Martin Abram and Clemens Philipp Schindler
Schindler Rechtsanwälte GmbH

Brazil 24
Carlos José Rolim de Mello, Alexandre Simões Pinto, Julio Antonio Nunes Queiroz, Bruno Sartori de Carvalho Barbosa, Patricia Eid, Vitor Arantes and Thais Martone
Souza, Mello e Torres Sociedade de Advogados

British Virgin Islands 30
Robert Varley and Rebecca Jack
Appleby

Canada 37
Andrae J Marrocco, Bruce Chapple and TE (Ted) Scott
McMillan LLP

Cayman Islands 42
Chris Humphries and James Smith
Stuarts Walker Hersant Humphries

China 51
Ping (Evan) Zhang
Han Kun Law Offices

Colombia 58
Jaime Trujillo
Baker McKenzie

Croatia 64
Branko Skerlev
BMWC Law Firm

Egypt 69
Nora Harb
Thebes Consultancy

Germany 74
Tarek Mardini and Sebastian Käpplinger
P+P Pöllath + Partners

Indonesia 81
Freddy Karyadi and Mahatma Hadhi
Ali Budiardjo, Nugroho, Reksodiputro

Israel 87
Miriam Haber, Rachel Arnin and Shemer Frenkel
Raveh Haber & Co

Italy 92
Dante Leone, Nicola Rapaccini and Barbara Braghiroli
CP-DL Capolino-Perlingieri & Leone

Japan 99
Makoto Igarashi and Yoshiharu Kawamata
Nishimura & Asahi

Korea 105
Je Won Lee and Kyu Seok Park
Lee & Ko

Luxembourg 111
Marc Meyers
Loyens & Loeff Luxembourg Sàrl

Saudi Arabia 122
Robert Eastwood and Omar Iqbal
Legal Advisors Abdulaziz Alajlan & Partners in association with Baker & McKenzie Limited

Spain 127
Carlos de Cárdenas, Alejandra Font, Víctor Doménech and Manuel García-Riestra
Alter Legal

Switzerland 135
Shelby R du Pasquier and Maria Chiriaeva
Lenz & Staehelin

United Kingdom 142
Richard Sultman, Jennifer Maskell, Catherine Taddeï, Beth Leggate and Hannah Esslemont
Cleary Gottlieb Steen & Hamilton LLP

United States 153
Thomas H Bell, Barrie B Covit, Peter H Gilman, Jason A Herman, Jonathan A Karen, Parker B Kelsey, Steven R Klar, Glenn R Sarno and Michael W Wolitzer
Simpson Thacher & Bartlett LLP

Transactions

Australia 165
Rachael Bassil, Peter Cook, Deborah Johns, Muhunthan Kanagaratnam and Hanh Chau
Gilbert + Tobin

Austria 173
Florian Philipp Cvak and Clemens Philipp Schindler
Schindler Rechtsanwälte GmbH

Brazil 180
Carlos José Rolim de Mello, Alexandre Simões Pinto, Julio Antonio Nunes Queiroz, Bruno Sartori de Carvalho Barbosa, Patricia Eid, Vitor Arantes and Thais Martone
Souza, Mello e Torres Sociedade de Advogados

British Virgin Islands 185
Andrew Jowett and Rebecca Jack
Appleby

© Law Business Research 2019

Canada 190
Andrae J Marrocco, Brett Stewart and Georges Dubé
McMillan LLP

Cayman Islands 196
Chris Humphries and James Smith
Stuarts Walker Hersant Humphries

China 200
Ping (Evan) Zhang
Han Kun Law Offices

Colombia 207
Jaime Trujillo
Baker McKenzie

Croatia 213
Branko Skerlev
BMWC Law Firm

Egypt 218
Aya Sabry and Nora Harb
Thebes Consultancy

Germany 221
Tim Kaufhold and Tobias Jäger
P+P Pöllath+Partners

India 227
Aakash Choubey and Sharad Moudgal
Khaitan & Co

Indonesia 235
Freddy Karyadi and Mahatma Hadhi
Ali Budiardjo, Nugroho, Reksodiputro

Italy 241
Giancarlo Capolino-Perlingieri and Maria Pia Carretta
CP-DL Capolino-Perlingieri & Leone

Japan 247
Asa Shinkawa and Masaki Noda
Nishimura & Asahi

Korea 253
Je Won Lee and Kyu Seok Park
Lee & Ko

Nigeria 259
Tamuno Atekebo, Eberechi Okoh, Omolayo Latunji and Oyeniyi Immanuel
Streamsowers & Köhn

Saudi Arabia 264
Omar Iqbal
Legal Advisors Abdulaziz Alajlan & Partners
in association with Baker & McKenzie Limited

Switzerland 269
Andreas Rötheli, Beat Kühni, Dominik Kaczmarczyk and Roman Graf
Lenz & Staehelin

Thailand 276
Jirapong Sriwat and Apinya Sarntikasem
Nishimura & Asahi (Thailand) Co, Ltd

Turkey 282
Noyan Turunç and Kerem Turunç
TURUNÇ

United Kingdom 288
David Billington, Michael Preston and Michael James
Cleary Gottlieb Steen & Hamilton LLP

United States 295
Bill Curbow, Atif Azher, Peter Gilman, Fred de Albuquerque and Jay Higdon
Simpson Thacher & Bartlett LLP

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Preface

Private Equity 2019

Fifteenth edition

Getting the Deal Through is delighted to publish the fifteenth edition of *Private Equity*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on the British Virgin Islands, Canada, Colombia, Egypt and Thailand. The report is divided into two sections: the first deals with fund formation in 22 jurisdictions and the second deals with transactions in 23 jurisdictions.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Bill Curbow of Simpson Thacher & Bartlett LLP, for his continued assistance with this volume

London
February 2019

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Canada

Andrae J Marrocco, Brett Stewart and Georges Dubé
McMillan LLP

1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

A wide range of private equity transactions is common in Canada, including going-private transactions, private investments in public companies and private company buyouts. In order to effect a direct acquisition of a Canadian target company, a private equity sponsor will almost always incorporate a Canadian acquisition vehicle, which will then acquire the target company by way of an acquisition of the securities or assets. In situations involving a large number of selling shareholders, either an amalgamation (similar to a US merger) or a court-approved plan of arrangement may be used.

The acquisition method (securities, assets, amalgamation or plan of arrangement) is dependent on various factors, including tax and legacy liability considerations, in addition to the parties' ability to leverage their positions in the negotiations.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or later become public companies?

In Canada, corporate board members generally have three fundamental statutory duties:

- the duty to manage or supervise the management of the corporation;
- a fiduciary duty to act honestly and in good faith with a view to the best interests of the corporation, including a duty to avoid conflicts of interest; and
- a duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Companies that remain or later become public companies are subject to additional corporate governance rules and enhanced disclosure requirements as compared with private companies. As such, these companies will be subject to higher administrative burdens and costs.

3 Issues facing public company boards

What are some of the issues facing boards of directors of public companies considering entering into a going-private or other private equity transaction? What procedural safeguards, if any, may boards of directors of public companies use when considering such a transaction? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

The potential liabilities of directors in default of observing their fiduciary duties can be extensive. Directors may be personally liable for breaching the duties of loyalty and of care, or, in other instances, held personally liable for wrongdoing by the corporation. In addition to fiduciary duties, over 100 federal and provincial statutes impose personal liability on directors of Canadian companies, including the corporate legislation governing the Canadian portfolio company, securities laws, environmental laws, employment, labour and pension laws, tax laws and bankruptcy and insolvency laws.

Under applicable Canadian corporate statutes, directors are required to disclose their interest (whether personal or via a related person's interest) in any proposed material contract or transaction with the corporation. As such, it is intended that all conflicts or potential conflicts of directors as a result of their relationship with the nominating party or other portfolio companies be disclosed. Subject to limited and narrow exceptions, conflicted directors must refrain from voting on any resolution to approve the contract or transaction giving rise to the conflict.

The appointment of an independent committee (or special committee) of directors is a typical method of protecting a board from potential conflicts of interest with respect to review of a proposed takeover. Where a board makes a decision based on the recommendation of an independent committee, that decision will generally be given a measure of deference by the courts, provided that the independent committee has discharged its role independently, in good faith and on reasonable grounds. Furthermore, it is standard practice for the independent committee to obtain a fairness opinion stating that the transaction is fair from a financial perspective.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Going-private transactions are commonly 'related party transactions' under Canadian securities laws, where the transactions involve the acquisition of a target company's outstanding securities by an existing significant shareholder or related party. In these scenarios, because the acquirer is a related party of the target company and public shareholders are being squeezed out of their equity interest, there are inherent conflicts of interest and inequalities of information.

Where the going-private transaction is a related party transaction heightened disclosure rules apply. Specifically, a formal, independent valuation of the target company's securities, which must be supervised by an independent committee of the target company's board and heightened disclosure, including disclosure of the background to the bid and any other valuations prepared or offers received for the target's securities in the past two years must be included in the disclosure document provided to holders of the affected securities.

5 Timing considerations

What are the timing considerations for negotiating and completing a going-private or other private equity transaction?

Timing of private equity transactions is largely a matter of negotiation, leverage and other business considerations. Where the private equity transaction is a going-private transaction that proceeds by way of plan of arrangement, it will generally require five to six weeks from receipt of the bidder's proposal to execution of the definitive arrangement agreement. Following execution of the definitive arrangement agreement,

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a shareholder meeting must be called and held and the court must approve the arrangement, which may take 10 to 12 weeks.

6 Dissenting shareholders' rights

What rights do shareholders of a target have to dissent or object to a going-private transaction? How do acquirers address the risks associated with shareholder dissent?

Most Canadian corporate statutes provide for shareholder approval of going-private transactions and grant shareholders the right to dissent and demand fair value for shares affected by such a transaction.

Where a going-private transaction is effected by way of takeover bid (described in further detail below), if the offeror acquires 90 per cent or more of the shares available (not including shares held by the offeror at the time the bid was made), the remaining shares can be acquired through a forced statutory transaction known as a minority squeeze-out. If less than 90 per cent of the outstanding shares are tendered to a takeover bid (not including shares held by the offeror at the time the bid was made), the balance may be acquired through a second-stage corporate transaction pursuant to which the offeror is entitled to vote the shares acquired under the takeover bid if (subject to provisions of applicable corporate law) the transaction is completed within 120 days of the expiry of the bid (a minimum tender condition of two-thirds will generally be sufficient to ensure that the offeror has sufficient votes to approve the corporate transaction).

7 Purchase agreements

What notable purchase agreement provisions are specific to private equity transactions?

Canadian deal terms are gradually merging with those prevailing in the US market mainly because of the influence resulting from the increased investment activities of US private equity investors in Canada.

Private equity buyers often require purchase price adjustments to reflect the financial condition of the target. Typically, these are based on a net working capital and debt adjustment. Private equity buyers often seek to negotiate earn-out provisions in order to align a portion of the consideration payable as part of the acquisition to the post-closing financial success of the target company (frequently structured as a reverse earn-out to avoid certain adverse vendor tax consequences associated with receiving traditional earn-out proceeds). Generally, private equity investors will seek to have the acquired companies or the shareholders that are related to members of the management provide typical representations and warranties regarding the acquired companies. Increasingly, these representations and warranties are backed by representation and warranty insurance.

In the current market we do not see a lot of financing conditions and Canadian takeover bids in particular require that adequate arrangements (an interpreted statement) must be made, with the effect that a bid cannot be conditional on financing.

Statutory plans of arrangement can be conditional in nature and allow for more flexibility to provide collateral benefits to management, etc. Owing to this flexibility, most Canadian privatisation transactions involving private equity sponsors are completed by way of a plan of arrangement. We often see break fees used in connection with no-shop conditions and, in public market M&A transactions, a no-shop provision will be subject to a fiduciary qualification.

8 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations for when a private equity acquirer should discuss management participation following the completion of a going-private transaction?

Many equity incentive tools are available in Canada to compensate management, including stock options, stock purchase plans, stock appreciation rights and deferred stock units. Traditional stock options are the most popular incentives as they are generally not subject to taxation until exercised and, subject to complying with certain rules, employee option holders may be eligible for a capital-gains equivalent tax rate.

Options granted under a Canadian stock option plan will generally vest during the continued employment of an option holder over a period of time, or upon the fulfilment of certain performance conditions such as revenue growth or bottom line financial returns. Also, any 'in-the-money' options will usually vest automatically in the event of a change of control transaction involving the company.

Often, management sellers will be expected, or at least offered the opportunity, to maintain a minority equity interest in the acquired entity. The terms and conditions of such minority interest will often require extensive negotiations between the parties. In these circumstances, private equity sponsors may favour structures involving dual classes of equity with one reserved for themselves, such class having priority over the class intended for the continuing management. Depending on the terms surrounding the issue of the equity to continuing management, the return enjoyed by management may be conditioned on a minimum threshold return to the private equity sponsor. In most cases, securities issued to management will be subject to repurchase rights in favour of the company upon a termination of employment. Both commercial and personal tax considerations impact the preferred equity structure for any particular transaction.

9 Tax issues

What are some of the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

Many tax and commercial factors influence the structure and financing of a private equity investment in Canada, and the options will vary depending upon the investors' status, residence and overall tax situation, including applicable tax rates and tax treaties.

Usually, tax and legacy liability considerations will cause a seller to favour a share sale whereas a purchaser would generally prefer an asset transaction. Hybrid transactions that involve the acquisition of both shares and assets of a target entity, typically providing tax advantages to both buyer and seller, may sometimes bridge the divide between sellers and buyers.

There is generally no withholding tax on interest paid to non-resident lenders that deal at arm's length with a Canadian-resident taxpayer, unless the interest is 'participating debt interest.' Interest paid to non-residents who do not deal at arm's length with the taxpayer is subject to withholding tax of 25 per cent unless reduced under an applicable tax treaty. For example, the Canada–United States Income Tax Convention (1980), as amended, (the US Treaty) generally eliminates Canadian withholding tax on conventional interest payments made to non-arm's-length US-resident lenders (assuming they are entitled to the benefits of the US Treaty). In most of Canada's other tax treaties, the reduced rate of withholding tax applicable to non-arm's-length lenders is 10 per cent.

Dividends paid by Canadian corporations to non-resident shareholders and royalties payable to non-residents will generally be subject to Canadian withholding tax at a rate of 25 per cent, unless reduced under an applicable tax treaty. For example, the reduced withholding tax rate in respect of dividends under the US Treaty is 5 per cent where the beneficial owner of the dividends is a US-resident corporation that owns at least 10 per cent of the Canadian subsidiary's voting stock (otherwise, the applicable US Treaty reduced rate is 15 per cent). The US Treaty reduced withholding tax rate in respect of royalties is 10 per cent.

US buyers will occasionally favour constituting a Canadian acquisition vehicle or Canadian operating subsidiaries as unlimited liability companies that have 'checked the box' to be treated as disregarded entities for US tax purposes. A US-resident entity establishing an unlimited liability company will need to be mindful of limitations under the US Treaty regarding access to treaty benefits by unlimited liability companies and the strategies endorsed by the Canadian tax authorities for accessing such benefits. If not so structured, the general statutory rate of withholding tax (ie, 25 per cent) will generally be exigible in respect of certain dividend, interest, royalty and other payments to the extent withholding tax is applicable. Notwithstanding the foregoing, unlimited liability companies are generally taxed as ordinary (ie, not disregarded) corporations for Canadian income tax purposes.

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Non-resident investors are generally not subject to Canadian tax on capital gains realised on a disposition of shares of a Canadian corporation. However, such non-resident investors may be subject to Canadian capital gains tax if, among other things, at any time in the 60 months preceding the sale the subject shares derived more than 50 per cent of their fair market value from real property situated in Canada, Canadian resource properties, timber resource properties or options in respect of such properties (and, in the case of publicly listed shares, if the non-resident, non-arm's-length persons and partnerships in which they hold membership interests held more than 25 per cent of the shares of any class of the corporation). Under certain of Canada's income tax treaties, including the US Treaty, the application of the tax is narrowed by applying it only to gains on sales of shares that derive their value from real and related property situate in Canada at the time the shares are sold.

10 Debt financing structures

What types of debt financing are typically used to fund going-private or other private equity transactions? What issues are raised by existing indebtedness of a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

The most common source of debt financing in a Canadian private equity acquisition remains the traditional senior secured debt obtained from a domestic Canadian bank. However, we see more financing being provided directly by US banks. Sometimes, a senior facility will be supplemented by mezzanine financing (most of the time provided by way of subordinated debt) provided by banks or other financial institutions. In the past few years, the high-yield bond market was not very active in Canada in connection with private equity acquisitions. High weighting in energy companies and the lack of liquidity are mentioned as reasons for this slow market. In many transactions that we are aware of the private equity investor provided a bridge loan with respect to a portion of the debt financing required for the acquisition and raised that portion of the debt post-closing.

Canada's thin-capitalisation rules effectively limit the proportion of debt to equity that significant non-resident shareholders and certain related persons may invest in Canadian corporations. Relevant equity of a Canadian corporation includes paid-up capital, contributed surplus paid by the non-resident shareholder or certain related persons and retained earnings such that the payment of a dividend or return of capital will generally reduce relevant equity for thin-capitalisation purposes. In general, arm's-length debt does not affect the thin-capitalisation limits. However, certain anti-avoidance measures may cause the thin-capitalisation rules to apply to certain back-to-back loan arrangements involving arm's-length intermediaries. The permitted debt to equity ratio of a Canadian corporation is 1.5:1. If the 1.5:1 ratio is exceeded, the Canadian corporation may not be able to deduct interest in respect of the excessive debt, and such denied interest payments may be treated as deemed dividends subject to non-resident withholding tax. The thin-capitalisation rules now also apply to other types of business vehicles, including trusts and non-resident corporations carrying on business in Canada.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in going-private transaction purchase agreements for private equity transactions? What other documents typically set out the financing arrangements?

Typical legal terms and conditions associated with debt facilities used in connection with a private equity-backed acquisition include:

- type of facility;
- security interest (usually a first lien over the assets in the case of a senior facility);
- borrowing base and funds available under the facility;
- repayment of capital;
- interest rate and interest payment;
- restrictive covenants, including with respect to debt, liens, dividends or acquisitions: the senior facility will provide for detailed covenants whereas any subordinated-debt facility would be expected to be covenant-light;
- conditions precedent to disbursement; and
- maturity date.

Comfort letters from the third-party lender or bank are often tabled as part of a bid to provide comfort with respect to the debt financing.

US private equity investors may have the ability to use US banks to finance their Canadian acquisitions as opposed to Canadian financial institutions. In such circumstances, hedging strategies and their costs to protect against currency fluctuations become important considerations in the selection of the debt provider, as well as the thin-capitalisation considerations described above.

12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving debt financing raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

Under the Bankruptcy and Insolvency Act (Canada) (BIA) and the Companies' Creditors Arrangement Act (Canada) (CCAA), Canada's key bankruptcy and insolvency legislation, certain transactions, including the granting of security, the transfer of property and the incurrence of financing obligations are voidable if incurred during specified pre-bankruptcy time periods. Subject to certain conditions and exemptions, including whether the target is insolvent at the time of the transaction, if such transactions are made with a view to giving one creditor a preference over others, they may be set aside if entered into during the period that is:

- three months before the initial bankruptcy event for transactions at arm's length; and
- one year before the initial bankruptcy event for transactions not at arm's length.

If solvency is an issue, a vesting order may be obtained through bankruptcy or reorganisation proceedings under the BIA or CCAA. However, the protections for creditors in these proceedings make the process expensive and less certain.

Transfers of property (or services sold) in which the consideration the debtor receives is less than the fair market value, subject to certain other conditions and exemptions, may be set aside under the BIA or CCAA if entered into during the period that is;

- one year before the initial bankruptcy event for transactions at arm's length; and
- five years before the initial bankruptcy event for transactions not at arm's length.

Preferential transactions and fraudulent conveyances may also be attacked under various provincial statutes.

In going-private transactions involving debt financing, it is typical for sponsors to conduct adequate financial diligence and to obtain solvency certificates from the target in order to provide some comfort around the target's financial status at the time of the transaction. However, the question of whether a particular transaction is voidable will be a question of fact determined by a court of competent jurisdiction.

In addition, under Canadian federal and provincial corporate legislation a 'stakeholder', including any creditor, can assert a claim against a Canadian or provincially organised target for actions that are oppressive or unfairly prejudicial to the complainant, or which unfairly disregard the complainant's legitimate expectations. Where oppression is found, courts have broad discretion to grant a variety of remedies, including the unwinding or avoidance of a transaction.

13 Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms or other equity co-investors? Are there any statutory or other legal protections for minority shareholders?

Typically, a private equity investor will put a unanimous shareholder agreement (a 'USA') in place at the closing of a private equity acquisition. Where multiple equity interests exist post-closing, parties to a USA must include all registered shareholders of all classes (whether

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voting, non-voting, common or preferred). A USA has a special 'hybrid' status, being partly contractual but also partly constitutional (eg, for certain purposes, notably determinations of de jure control), the USA is considered one of the 'constating documents' of the corporation. What this means, practically speaking, is that shareholders who enter into a USA can avoid certain statutory requirements, something that cannot ordinarily be achieved through contract. Most significantly, a USA can limit the powers that a corporation's directors normally exercise, directly or through their oversight of management, over a corporation. Under a USA, private equity investors will usually require the appointment of nominees to the board of directors. Private equity investors may also use a USA to maintain a veto over amendments to the articles, a change in the nature of the business, the annual business plan, amalgamations or other business combinations, the issuance of securities or significant non-arm's-length transactions and other non-ordinary-course events.

In order to qualify the corporation as a private issuer for securities law purposes and for other business reasons, the corporation's articles or a USA will include a restriction on the transfer of securities (save and except as otherwise specifically provided in the agreement to certain permitted transferees).

Private equity investors typically also require that USAs include drag-along rights and share buyback provisions to ensure they maintain flexibility of exit.

Certain provinces have additional rules (including approval by a majority of the minority shareholders and independent valuations of the subject matter of the transaction) designed to ensure fair dealing in the treatment of minority shareholders in certain types of transactions involving controlling shareholders or related parties (which include shareholders owning 10 per cent or more of the voting securities of a corporation).

14 Acquisitions of controlling stakes

Are there any legal requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

The acquisition of a Canadian public company may be structured as a corporate transaction or a takeover bid. The rules for acquiring a Canadian public company are complicated and involve aspects of securities, corporate and administrative law.

Corporate transactions typically take the form of a plan of arrangement (which requires court approval before implementation), statutory amalgamation or other corporate reorganisation, and require the approval of the target's shareholders at a shareholders' meeting.

A takeover bid is the Canadian equivalent of a US tender offer. The offeror must follow a prescribed process when launching and completing a bid.

Under Canadian securities law, a takeover bid to shareholders of a Canadian public company to acquire a prescribed percentage of the company's outstanding voting or equity securities:

- must be made by way of a formal offer to all shareholders and may be commenced by way of an advertisement (typical in hostile bids) or by mailing the offer documents (typical in negotiated or friendly bids);
- must offer identical consideration to all shareholders and may not, subject to certain exceptions, include a collateral arrangement that has the effect of providing one shareholder with consideration of greater value than that offered to other shareholders;
- must abide by the minimum tender condition that a minimum of more than 50 per cent of all outstanding target securities (excluding securities held or controlled by the offeror and its joint actors) be tendered and not withdrawn before the offeror can take up any securities under the bid;
- must be open for acceptance for a period of at least 105 days, subject to two exceptions discussed below; and
- must be extended for at least an additional 10-day period following the satisfaction of the 50 per cent minimum tender requirement and all other terms and conditions of the bid being complied with or waived.

The formal takeover bid requirements are triggered when the securities subject to a bid combined with the securities owned, directly or indirectly, by the offeror and its joint actors constitute 20 per cent or more of the outstanding securities of any class of voting or equity securities.

A person who acquires beneficial ownership of, or the power to exercise control or direction over, or securities convertible into, 10 per cent (5 per cent if another takeover bid is outstanding) or more of a class of voting or equity securities of a Canadian public company is required to issue a press release and file an early warning report containing prescribed information. Further press releases and reports are required upon the acquisition of each additional 2 per cent or more of the outstanding securities of the same class, as well as upon dispositions resulting in a decrease in ownership of 2 per cent or the purchaser falling below the 10 per cent threshold. An alternative early warning regime is applicable to eligible institutions.

The takeover bid can be in cash, securities or a combination. However, it may not be conditional upon obtaining financing. Financing arrangements may only be subject to conditions if, at the time the bid is commenced, the offeror reasonably believes that the likelihood that it will be unable to pay for the securities deposited under the bid solely owing to a financing condition not being satisfied is remote.

An offeror commencing a takeover bid is required to prepare and send out a takeover bid circular in prescribed form. The circular must be sent to all holders of the class of shares that is the subject of the bid (including holders of securities convertible for such shares), but the offer can be for less than all of the outstanding shares of the class provided that the minimum 50 per cent tender requirement is included.

Under applicable corporate law, the offeror may request a list of the target company's shareholders, which the target company is required to provide. In cases where shares have been tendered and the offeror subsequently increases the consideration under the offer by amending the bid, those who have previously tendered their shares benefit from the higher consideration.

Bids are subject to a mandatory, non-waivable minimum tender requirement of more than 50 per cent of the outstanding securities of the class that are subject to the bid (excluding those beneficially owned, or over which control or direction is exercised, by the offeror and its joint actors). The offeror may set a higher tender threshold (typically 66.67 per cent) where the objective is to acquire all of the outstanding target shares, in order to ensure that it will acquire sufficient shares to effect a second-stage going-private transaction.

Takeover bids are required to remain open for a minimum of 105 days, subject to two exceptions. First, the board of directors of the target may issue a 'deposit period news release' in respect of a proposed or commenced bid providing for an initial bid period that is shorter than 105 days but not less than 35 days. This will also entitle any outstanding or subsequent takeover bid to the shorter minimum deposit period counted from the date such bid is made. Second, if an issuer issues a news release that it has entered into an 'alternative transaction' – effectively a friendly change of control transaction that is not a takeover bid, such as an arrangement – then any other outstanding or subsequent bid will be entitled to a minimum 35-day deposit period counted from the date such other bid is made.

If the bid conditions have been fulfilled or waived at the end of the initial deposit period, the offeror must immediately take up all deposited shares and pay for them as soon as possible and in any event not later than three business days after they are taken up. Shareholders can withdraw their tendered shares at any point in time before the securities are taken up by the offeror, within 10 days of a change to the bid, or after the shares have been taken up if they have not been paid for within 10 days. Most amendments to a bid require the bid be kept open for at least 10 days following the amendment.

If there is a successful takeover bid where the offeror is looking to acquire fewer than all of the outstanding securities, shareholders who tender to the bid will have their shares taken up pro rata and not on a first-to-tender basis.

The acquisition of a Canadian private company is not subject to these same requirements and provided all of the shareholders are active participants in the sale, statutory consents to the transfer of the shares are typically not required.

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Update and trends

Notwithstanding the lingering uncertainty surrounding Canada's economic relations with the United States, Canada is likely to remain an attractive destination for private equity investment over the coming years. This is largely the result of both the anticipated growth in the Canadian economy and increasing competition among private equity funds to seek out new territory. The consumer goods, industrials and chemicals, oil and gas and technology industries in Canada in particular are poised to see increased private equity investment in future.

Franchise mergers and acquisitions

Additionally, private equity's interest in franchise systems continues to grow in Canada. Use of the franchise business model as an expansion strategy has been on the rise across the globe for many years, and its contributions to national gross domestic product and job creation have outperformed other sectors. Franchise systems have progressed well beyond traditional quick-service restaurants and now encompass businesses across numerous industries and sectors across international jurisdictions. As a result, franchise businesses have increasingly become a focus for private equity and have been the subject of notable transactions, such as the C$12.64 billion tax inversion deal involving Burger King Worldwide and Tim Hortons engineered by Brazilian private equity firm 3G Capital.

Understanding the franchise business model framework and mechanics has become paramount for advising on franchise-related M&A transactions, particularly as the arrangements and relationships within franchise systems are now more complex, multifaceted and international. It is also important to note that the franchise sector has been subject to an increasing amount of direct and indirect regulation across numerous jurisdictions, and is increasingly a highly litigious area.

15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a strategic or private equity acquirer?

Most sell-side transactions are run by way of auctions. While timing may vary, an auction process usually takes three months from launch to reach terms with a preferred bidder. Transactions will then generally complete within 30 to 45 days if no regulatory approvals are required and within 60 to 90 days if regulatory approvals are required.

Private equity sellers generally insist on limiting post-closing exposure as much as possible. They typically limit the length and scope of indemnity provisions as much as possible, as well as other post-closing covenants and undertakings.

In addition, they strive to limit the scope of the representations and warranties and the duration of the survival period of same. They will typically push back on the inclusion of full disclosure (10b-5 type) representations and warranties, and will insist on the inclusion of materiality qualifiers and anti-sandbagging provisions.

Representation and warranty insurance is being increasingly used as a competitive tool in deal negotiation by private equity firms. Typical carve-outs to these policies include pending litigation, environmental liabilities, future adverse tax rulings, criminal matters, fraud, underfunded benefit plans and bribery and anti-corruption matters. The recent increase in the use of representation and warranty insurance has materially affected the foregoing.

16 Portfolio company IPOs

What governance rights and other shareholders' rights and restrictions typically survive an IPO? What types of lock-up restrictions typically apply in connection with an IPO? What are common methods for private equity sponsors to dispose of their stock in a portfolio company following its IPO?

A common share IPO is rarely a 100 per cent exit for a significant investor. Even when a substantial block of existing shares can be sold, it may need to be shared between all would-be sellers, unless the private equity investor has pre-negotiated preferred status on the exit. Needless to say, regulators, underwriters and prospective investors will have requirements as to how much of the IPO can be made up of existing stock to pay out departing shareholders versus new stock to assist the company itself. Further issues arising on an IPO include (among many others) who will sign the prospectus certificate as a promoter and agree to indemnify the underwriters, how the board will be constituted (and any special veto rights), provisions for the amendment of articles and by-laws, escrow arrangements or other resale restrictions, expense allocation and the extent of management road-show participation obligations.

Going public may attract the highest return for private equity investors, depending on market conditions, but the transaction cost is high and the process is often long and unpredictable. Private equity investors also may not be able to make a clean exit; they will often be asked to enter into a lock-up agreement and commit not to sell shares for a period of six to 12 months following an IPO. Additionally, rules of the applicable securities exchange may require persons who have acted as a promoter of the company, significant holders of the company's securities and directors or officers of the company to enter into escrow agreements ranging in term from 18 to 36 months.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in industry focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

The sectors likely to provoke the most interest on the part of investors are consumer goods, industrials and chemicals, and technology. As for the crucial energy sector, it remains to be seen whether higher prices will give the sector the boost it needs to overcome the recent downturn and domestic political and regulatory challenges.

In certain industries, including broadcasting, telecommunications and financial services, Canadian legislation may limit the rights of non-Canadians to own securities of companies involved in such industries. For example, companies subject to the Telecommunications Act (Canada) and having market shares of 10 per cent or more may not be controlled by non-Canadians and their ability to own securities in such companies is limited by law.

18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or other private equity transaction?

A non-resident making a private equity investment in Canada will typically establish a Canadian acquisition subsidiary to obtain more favourable tax treatment. Among other advantages, using a Canadian acquisition subsidiary facilitates the deduction of financing expenses and the return of paid-up capital. Additionally, incorporating a Canadian subsidiary may allow foreign investors to take certain assets out of the target post-closing on a tax-free basis and reduce taxes payable pursuant to the foreign affiliate dumping rules. The direct or indirect acquisition of control of a Canadian-controlled private corporation by a non-resident could cause the target to lose access to certain research and development tax credits and other favourable tax treatment.

The acquisition by a non-Canadian of control of a Canadian business that exceeds certain prescribed monetary thresholds is reviewable under the Investment Canada Act (ICA) and subject to approval by the federal Minister of Innovation, Science and Economic Development or the Minister of Heritage (depending on the nature of the business of the Canadian company). Transactions below the applicable threshold are subject to a notification process. It should be noted that the ICA presumes that the acquisition of one-third or more of the voting shares of a Canadian corporation is an acquisition of control unless it can be established that, on the acquisition, the corporation is not controlled in fact by the acquirer through the ownership of voting shares. In addition, under the ICA, the federal Ministers of Industry and of Public Safety and Emergency Preparedness have the discretionary power to review

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any investment by a non-Canadian (including investments below the control threshold) where there are reasonable grounds to believe that the investment could be injurious to national security.

19 Club and group deals

What are some of the key considerations when more than one private equity firm, or one or more private equity firms and a strategic partner or other equity co-investor is participating in a deal?

Key considerations that arise in co-investment arrangements include:

- Control:
  - in a private equity fund controlled by a sponsor, co-investors will typically limit the powers of the sponsor by way of veto rights negotiated in the shareholders' agreement. In addition to changes to the constating documents and other material decisions, minority co-investors generally want to limit the sponsor's ability to contract with related parties. Also, co-investors will seek to obtain minority investor rights such as representation on the board of directors of the general partner of the fund and pre-emptive rights to avoid dilution in case of securities offering as well as they say in any material changes to the shareholders' agreement of the general partner and to the limited partnership agreement forming the private equity fund;
  - in a private equity fund not controlled by a sponsor, the co-investors will generally negotiate board representation rights among themselves to ascertain that no co-investor alone controls the fund. In many cases, proportional investor rights will be granted to co-investors and mechanisms will be in place to avoid any co-investor taking control of the private equity fund without the affirmative consent of a certain number of other co-investors; and
  - sponsor and co-investors will typically negotiate certain approval thresholds to permit changes to the constating documents of the private equity fund without the unanimous consents of all co-investors. The level of the thresholds will vary depending on the particular circumstances of each private equity fund and the ownership thereof. The objective sought is to protect the rights of the minority co-investors but not at the expense of a certain majority of co-investors.
- The alignment of liquidity: co-investors generally want to be able to monetise in parallel with the sponsor fund. Co-investors usually attempt to negotiate a right to exit an investment simultaneously with the sponsor fund. Typically, this is achieved through tag-along and registration rights contained in the shareholders' agreement or in the limited partnership agreement.
- The retention of syndication rights: sponsor funds usually seek to preserve the right to syndicate a portion of their interest in the target company after closing the M&A transaction without the application of co-investors' liquidity rights. Co-investors may seek to limit the period during which a post-closing syndication can take place. They may also seek to establish a minimum equity hold for the sponsor fund.
- The allocation of expenses between investors: passive co-investors are generally required to bear expenses relating to the formation and operation of the co-investment vehicle. Co-investors also typically bear their pro rata share of transaction expenses in connection with the closing (or failure to close) a transaction. Co-investors often attempt to negotiate a cap on these expenses.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity acquirer related to certainty of closing? How are these issues typically resolved?

Deal certainty is always a consideration, particularly in an auction process. Financing conditions in a transaction worth less than C$100 million would be unusual. A 'hell-or-high-water' approach to regulatory conditions is also becoming more prevalent from the sell-side perspective.

While still not usual, reverse break fees are trending upwards in Canadian private equity transactions. They will usually be contemplated in purchase agreements in a fixed dollar amount. Owing to the increased exposure of the target entity to potential damage from a failed deal, reverse break fees are often higher than the negotiated break fee on a transaction.

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