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**U.S.-CANADA DEALS:  
WHEN THE TARGET IS CANADIAN  
SUBTLE DIFFERENCES**



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Merger and acquisition activity in Canada over the last year has been intense, driven by the same factors affecting the U.S. market but with the added incentive of a low Canadian dollar. Many of these transactions have been cross-border deals involving U.S. and Canadian companies. While there are any number of variations in cross-border deals, many of the transactions involved the acquisition by a U.S. acquiror of a Canadian target.

This article identifies the key Canadian legal principles which a U.S. acquiror should know if contemplating the acquisition of a Canadian target. It is not a compendium of all the issues which need to be addressed in structuring a transaction; many of those are the same whether the acquisition is of a Canadian or U.S. target.

## **Hostile Deals**

Where a hostile bid is launched in Canada, it is almost certain that a change of control transaction will occur. That is not to say that defensive action will not be taken by the target; to the contrary, the target will take steps to delay a hostile bid in order to solicit competing transactions and/or structure other value-enhancing transactions. One other frequent response is for the target to implement a poison pill if it does not already have one in place. Canadian securities regulators have adopted a policy, however, that defensive tactics must not prevent shareholders from being able to ultimately accept an offer. Accordingly, Canadian securities regulators will "cease trade" a poison pill once they have concluded that the directors of the target have had sufficient time to respond to a bid. Sufficient time is usually no more than 35 to 45 days.

American lawyers have described the Canadian regime as meaning, in effect, that Canadian companies are always "up for sale" (in terms of the so-called *Revlon* duties imposed by U.S. courts on directors of a target). Canadian courts have, however, been decidedly unreceptive to arguments made by hostile bidders that a target board has acted in breach of its fiduciary duties in responding to a bid. While the U.S. formulation of the business judgment rule has not been adopted in Canada, Canadian courts have consistently deferred to the business judgment of directors, provided their actions were reasonable in the circumstances. There is no onus on directors to demonstrate the "entire fairness" of any response to a bid or, necessarily, to conduct an auction.

## **Friendly Deals**

Most change-of-control transactions in Canada occur in friendly transactions. The form of the agreements entered into in connection with such transactions is very similar to the agreements which one would see in a purely domestic U.S. acquisition.

Invariably, Canadian merger agreements contain a "fiduciary out" in favor of the target board in the event of a higher value competing transaction, and usually provide for a cash "break fee"; fees must be reasonable and are usually in the range of 2 percent to 5 percent of the equity value of the transaction. Options on equity shares of the target are rare (and are strongly resisted by target boards) and are generally granted only where there has been a full auction. Significant shareholders can be irrevocably locked-up although that is a matter for negotiation.

## **Acquiring a Toe Hold**

Generally, Canadian securities laws permit a potential bidder to acquire a toe hold position in a potential Canadian target, although insider trading rules restrict purchases by insiders of the acquiror and

"tippees." Before making such purchases, however, there are two rules which a potential acquiror must consider.

First, there is an "early warning" disclosure obligation triggered where a person acquires 10 percent or more of a class of voting or equity securities. Because of this requirement, potential acquirors typically acquire no more than 9.9 percent of the shares of the target, at least until the acquiror is prepared to launch the bid. The early warning requirement operates in a manner which is significantly different from the requirements of §13(d) of the United States Securities and Exchange Act of 1934, as amended (Exchange Act). Under the Canadian rule, a purchaser must immediately stop purchasing and issue a press release (and file a report) upon making the specific trade that puts the acquiror to or through the 10 percent threshold.

Second, a "pre-bid integration rule" provides that if within the 90 days preceding the making of a bid, the bidder has acquired shares pursuant to a transaction not generally available on identical terms to all shareholders, the bidder must offer, pursuant to the bid, consideration in the same form and with at least the same value or at least the cash equivalent. In addition, if the bidder purchased all of the shares of a particular seller in a pre-bid transaction, the bidder must bid for all of the shares of the target. Accordingly, this rule is an issue only where the bidder purchased for cash in a pre-bid transaction and wishes to offer securities under the bid or to bid for less than all of the target shares.

### **Acquiring All Target Shares**

Most bidders want ultimately to acquire 100 percent of the target shares. Under many Canadian corporations statutes, a bidder which acquires, pursuant to a bid, at least 90 percent of the target shares (not owned by the bidder and its associates), has available a process (which does not require shareholder approval) under which the bidder, upon giving notice to the remaining shareholders, can mandatorily acquire the shares not tendered to the bid. While minority shareholders are entitled to apply to court for a determination of the fair value of their shares, the bidder is certain of being able to acquire all shares held by the minority shareholders.

Where the 90 percent squeeze-out mechanism is not available, the bidder can acquire the remaining minority shares through a subsequent squeeze-out transaction, typically structured as an amalgamation. Approval of such a transaction usually requires (depending on the corporate statute) approval by two-thirds of the votes cast. But, for this purpose, the bidder can vote the shares acquired pursuant to the prior bid in favor of the amalgamation. A shareholders' meeting is required to authorize the subsequent amalgamation transaction because Canadian corporate statutes require that a signed resolution, to be effective, must be signed by all shareholders.

An amalgamation transaction also requires minority shareholder approval (by majority vote) and the preparation of an independent valuation of the shares of the target. The bidder is entitled, however, to treat shares tendered to the prior bid as shares voted by minority shareholders in favor of the back-end going private transaction. There is also an exemption from the valuation requirement available.

Shareholders generally also have the right, in connection with an amalgamation, to apply to court for a determination of the fair value of their shares (referred to as "dissent rights," which generally correspond to U.S. appraisal rights), and the court could require such consideration to be paid in cash even if the prior bid offered shares of the acquiror.

As a result of these rules, if a bidder acquires sufficient shares under a bid to hold at least 66-2/3 percent of the outstanding shares, and if at least a majority of the shares held by minority shareholders

are tendered, the bidder is certain that it will be able to carry the votes required to approve the amalgamation squeeze-out. As a result, most Canadian take-over bids are conditional upon sufficient shares being tendered to meet these thresholds.

## **Plans of Arrangement**

While a take-over bid is the only practical choice for a hostile acquisition, friendly deals are frequently structured as a "plan of arrangement," often for tax reasons. A plan of arrangement may simply be a bid masquerading in a different form.

A plan of arrangement involves the target company applying to court for an order convening a shareholders' meeting to approve the transaction, and specifying the level of approval required (usually 66-2/3 percent of the votes cast). The company then convenes the shareholders' meeting in the usual manner and obtains the necessary shareholder approval. The company returns to court immediately after the shareholders' meeting to obtain a final order permitting completion of the transaction. In order to approve the transaction, the court must conclude that the transaction is fair to shareholders.

One advantage of a plan of arrangement is that any shares issued to U.S. shareholders of the target under the arrangement are exempt from registration under §3(a)(10) of the U.S. Securities Act of 1933, as amended. One disadvantage of an arrangement is that the court approval process provides a forum for disgruntled shareholders to appear and object to the transaction. In the very few cases in which that has occurred, Canadian courts have not been receptive to objections made by minority shareholders.

## **Share Exchanges**

Where the consideration offered in connection with a take-over bid or plan of arrangement is shares of the U.S. acquiror, under current Canadian tax law the exchange of such shares is a taxable transaction for Canadian resident shareholders. In contrast, shares of a Canadian incorporated company issued on such an exchange can qualify for a tax deferred roll-over even if they are exchangeable at the option of the holder into shares of a U.S. company.

Accordingly, a U.S. acquiror may wish to implement an exchangeable share structure in order to provide Canadian shareholders with the option of obtaining a roll-over. The U.S. acquiror would incorporate a wholly-owned Canadian company which would issue its shares to Canadian residents. The shares of the Canadian subsidiary would be exchangeable at any time at the option of the holders into the shares of the U.S. acquiror on the same basis offered under the transaction. The transaction is structured so that the exchangeable shares are the economic equivalent of directly holding the shares of the U.S. acquiror.

The exchangeable share structure will typically be collapsed through a forced exchange in the event that there ceases to be some specified minimum number of exchangeable shares outstanding or after a specified number of years. With respect to the latter, the sunset period has typically been not more than 10 years, although recent deals have extended that period.

In October 2000, the Canadian federal government announced that it intends to develop a roll-over rule for Canadian resident shareholders where the only consideration received is shares of a foreign company. If such a rule is implemented, it may eliminate use of exchangeable share structures.

## **Reporting Status**

Where a U.S. acquiror is offering its own securities in exchange for shares of a Canadian target, it must consider whether, by completing the transaction, it may have triggered on-going Canadian reporting obligations (similar to those imposed under the Exchange Act on publicly traded companies). Under Ontario securities laws, the U.S. acquiror does not typically become a "reporting issuer" subject to such requirements (although in connection with implementing an exchangeable share structure, a U.S. acquiror will be required to file U.S. reporting documents with Canadian securities regulators). In other Canadian provinces, the U.S. acquiror may become a reporting issuer by reason of the transaction, but will be able to obtain discretionary relief from Canadian reporting obligations conditional upon the filing of its U.S. reporting documents.

One of the significant differences between the Canadian and U.S. reporting rules is that a Canadian reporting issuer has a legal obligation, where a "material change" has occurred, to forthwith issue and file a press release disclosing the nature and substance of the change. A U.S. reporting issuer is required to file a Current Report on Form 8-K under the Exchange Act upon the occurrence of certain specified events, such as material acquisitions, dispositions of assets or bankruptcy. In the absence of such a specified event, a U.S. reporting issuer generally has no affirmative obligation to make disclosure unless it is issuing securities.

## **Potential for Litigation**

There is clearly the potential for litigation in Canada in connection with a hostile bid. Notwithstanding, Canada is a less litigious society than the United States, and Canadian courts have not generally been prepared to tolerate frivolous actions or strike suit litigation.

As a matter of law, breach of a Canadian statutory provision does not give rise to a civil cause of action in favor of an affected party unless the creation of such a remedy was contemplated by the relevant statute. In addition, in the securities area, Canadian courts have not adopted the U.S. "fraud on the market" theory as a basis for civil action. In contrast, Canadian securities regulators have broad discretion to police the take-over bid rules and to intervene in capital market transactions where they consider it to be "in the public interest" to do so. Securities commissions will not, however, consider issues related to whether directors of a target have complied with their fiduciary duties as directors. That is a corporate law issue for determination by the courts.

## **The Investment Canada Act**

Where a Canadian business with a book value of at least Cdn.\$209 million is to be acquired by a U.S. person, approval of that transaction by the federal Minister of Industry is required under the Investment Canada Act (Canada) before the acquisition can be completed.

In reviewing the transaction, the Minister will consult with the Canadian provinces affected and, to approve the transaction, must conclude that the acquisition will likely be of "net benefit" to Canada. In certain culturally sensitive areas (such as the publication, distribution and sale of books, magazines, periodicals, newspapers, video products or music recordings, or the carrying on of radio, television or cable broadcasting undertakings), a separate review by the Minister of Heritage is required where the Canadian business has assets of Cdn.\$5 million or more.

While it is unusual for a transaction not to be approved, U.S. acquirors should be prepared to negotiate undertakings with respect to the target's on-going business which justify the Minister's approval.

Depending on the circumstances, Investment Canada review can delay the completion of a transaction beyond the time otherwise necessary.

### **Less Than All Bids**

Occasionally, a U.S. acquiror will bid for control of a target and not for 100 percent of the outstanding shares. While it has been argued before Canadian regulators that a less than all bid is per se coercive of shareholders, securities regulators have rejected that argument.

**Related Party and Going Private Transactions.** A bidder for less than all the shares of a target should, however, be aware that there are Canadian rules which regulate related party transactions (i.e., a transaction between the acquiror and the target after completion of the bid, if the acquiror holds 10 percent or more of the voting rights) and going private transactions (i.e., a transaction under which the acquiror acquires all of the shares held by the public). Unless exemptions are available, such transactions require the preparation of an independent valuation, approval by majority vote of minority shareholders, consideration of the use of an independent committee of directors to approve the transaction and a heightened level of disclosure. If the value of a related party transaction is less than 25 percent of the market capitalization of the relevant issuer, the valuation and minority approval requirements do not apply.

**Oppression Actions.** In addition, a number of Canadian corporate statutes contain a so-called oppression remedy. Canadian courts are given a very broad discretion to intervene where actions of a corporation, its affiliates, directors or officers is oppressive or unfairly prejudicial to, or unfairly disregards, the interest of any security holder, creditor, director or officer. To be entitled to a remedy, a complainant does not have to show bad faith or wrongdoing, but simply that the relevant actions or omissions have had the effect referred to above. A remedy will be available where the court concludes that the "reasonable expectations" of a shareholder have been frustrated.

### **Miscellaneous Matters**

The Province of Nova Scotia has a corporate statute that permits the incorporation of an unlimited liability corporation. This can be useful because, for U.S. tax purposes, such a corporation may be treated as a non-recognized entity even though for Canadian tax purposes, it is taxed as an ordinary Canadian corporation.

A number of Canadian corporate statutes require that a majority of the directors be resident Canadians. This requirement can be avoided by incorporating or exporting the relevant company to a provincial jurisdiction which does not have this requirement.

### **U.S. Securities Law Issues**

U.S. acquirors and their advisors should bear in mind that in addition to Canadian regulatory requirements discussed in this article, in the event that a Canadian target has U.S. shareholders, the U.S. acquiror will also have to comply with applicable U.S. securities laws. The extent of any such U.S. securities law compliance will vary greatly depending on the type of transaction, the percentage of

shareholders of the target who are U.S. shareholders and whether or not the target is registered under the Exchange Act. A full discussion of these requirements would constitute a full-length article in and of itself.

## **Conclusion**

U.S. acquirors will find many of the statutory and legal principles applicable to the acquisition of a Canadian target to be familiar. That acquisition can be structured in substantially the same manner as an acquisition of a U.S. target. There are, however, subtle (and not so subtle) legal and regulatory differences of which U.S. acquirors need to be aware.

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