M&A

Top Trends
2014

Torys looks ahead to the 10 trends that will shape M&A.

TORYS

Top Trends
2014

The year 2013 saw boardrooms continue to undergo change. A rise in shareholder activism is influencing corporate governance practices, and boards are more active than ever before. In the M&A context, target boards are becoming engaged at an earlier stage. They are meeting more frequently and supervising management's negotiations more closely, especially where conflicts of interest are prevalent. We expect this focus on robust sales processes will continue in 2014.

With boards becoming more engaged, they will increasingly demand broader rights to protect their fiduciary duties. And we expect deal terms will come under pressure. For related party transactions, we predict that special committees of independent directors will take centre stage in negotiating transactions in order to benefit from the most deferential treatment by the courts and regulators and to help withstand criticism from discontented shareholders.

The tough deal-making environment in 2013 created acquisition opportunities for firms that had access to capital and, in some cases, spurred innovative deal practices. In other cases, it encouraged corporations, particularly in the resource sector, to shed non-core businesses and focus on capital efficiencies – a trend we expect will continue in 2014. Sales of quality assets are drawing interest from a significant number of private equity firms, especially U.S.-based firms. Private equity firms are doing what it takes to win competitive auctions and gain an advantage in this environment, including by building deep sector-specific expertise in-house. The presence of U.S. financial buyers in Canada will also continue to influence deal financing terms, as acquisition financing takes cues from the United States.

Foreign buyers of Canadian targets will encounter stricter tax rules that will have an impact on the planning and structuring of cross-border deals in 2014. Although some buyers may be concerned that they will also face longer regulatory review timelines, we predict that in most cases, these concerns are not warranted.

Torys looks ahead to the 10 trends that will shape business in 2014.

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1 THE SPECIAL COMMITTEE WILL TAKE CENTRE STAGE

James Tory, Andrew Beck, Aaron Emes

The use of special committees of independent directors has long been a feature of both Canadian and U.S. M&A practice as a means to address conflicts in related party transactions. It is well established that if a special committee approves or recommends a transaction, this may help in defending the transaction against attack from minority shareholders or securities regulators. However, the special committee process requirements to qualify for deference from courts or regulators and the degree of deference that will be shown have been subjects of legal debate.

Recent developments in Canada and the United States confirm the utility of special committees in related party transactions and emphasize the importance of their being broadly empowered for the transaction to qualify for the most deferential treatment from courts and regulators. As a result, we expect to see a more prominent role for special committees in related party transactions, with a potentially significant effect on deal dynamics.

The leading development in the United States was the recent landmark decision of the Delaware Court of Chancery in *In Re MFW Shareholders Litigation*. The Court held that a freeze-out merger with a controlling shareholder that was conditioned from the outset on (i) negotiation and approval by a fully empowered special committee of independent directors, and (ii) approval by an uncoerced and fully informed vote of a majority of the minority shareholders would qualify for the most deferential standard of review – the business judgment rule standard – rather than be subject to the more exacting "entire fairness" standard.

This is extremely important in the U.S. litigation context. It means that a strike suit attacking the transaction can be dismissed by summary judgment, depriving plaintiffs of the leverage they would otherwise have to extort a settlement as the price of removing the litigation obstacle to consummate the transaction.

The Court held in *MFW* that to get the benefit of the most deferential standard of review, the special committee process leading up to an affirmative vote of a majority of the minority shareholders must satisfy the following significant preconditions that concern the efficacy of the special committee as a bargaining agent on behalf of the minority:

- *independence*: committee members must be free of conflicts;
- *broad empowerment*: the committee must have the power to negotiate, including to definitively say no to a transaction (not just review it and make a recommendation), and to select its own advisers freely;
- *satisfaction of duty of care*: in evaluating, negotiating and agreeing to a transaction, the committee must act on a fully informed basis.

In Canada, the legal framework for related party transactions has been largely prescribed by securities regulators rather than by the courts, through Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions*, and its Companion Policy and through the regulators' intervention in transactions under their public interest jurisdiction.

Multilateral Instrument 61-101 compels the formation of a special committee of independent directors only in limited circumstances. However, the Companion Policy and the regulatory jurisprudence (most notably, *Re Magna International Inc.*) express both the expectation of regulators that special committees will normally be used in related party transactions and their view that for a transaction to qualify for deferential treatment based on the involvement of a special committee, process standards consistent with those articulated in *MFW* must be met. Ontario securities regulators have indicated that rule changes are coming to mandate such process requirements for related party transactions.

As a result of these developments, we expect to see special committees play a more prominent role in related party transactions, with their role shifting from overseeing negotiations and evaluating the resulting deal to one of directly negotiating the transaction. Special committee mandates will also be broader, reflecting the expanded authority of the special committee.

Implications for Deal Dynamics

The implications for deal dynamics of an increasingly influential special committee will likely include:

1

Early-stage appointment:
the appointment of a special committee in a proposed related party transaction at an early stage, so that the special committee is truly in a position to negotiate the transaction and give proper consideration to alternatives (rather than merely being asked to sign off on a transaction previously negotiated by related parties and management);

2

Direct interaction with principals:
direct interaction of the special committee with the principals of the related parties (rather than speaking solely through management); and

3

Enhanced role for special committee advisers:
advisers to the special committee (including financial and legal advisers) playing a greater role in advising on the terms of related party transactions (rather than merely advising on matters related to process and fairness).

Business Judgment Rule Standard

The courts will defer to the business decisions of unconflicted directors, provided that directors acted on an informed basis and their decision fell within a "range of reasonableness" (the Canadian version of the rule) or unless their decision could not be "attributed to any rational business purpose" (the Delaware version of the rule).

Entire Fairness Standard

A more exacting standard applied by U.S. courts that requires courts to be satisfied that the transaction under review was the product of fair dealing and resulted in a fair price.

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2 CONTINGENT VALUE RIGHTS AND SIMILAR TOOLS ARE BECOMING MORE COMMONPLACE

John Emanoilidis, Mile Kurta, Thomas Yeo

Of all the legal and business issues that arise in an M&A transaction, the most fundamental issue is valuation. If the buyer and seller cannot come to a meeting of the minds on the value of the business or the consideration to be paid, saving the deal becomes a matter of bridging that valuation gap. In 2014, we expect that buyers and sellers will increasingly use innovative pricing tools to reconcile their differences.

In the private company context, the most common way to bridge gaps in valuation is through an earnout formula. If the business performs as promised and achieves certain financial or other performance milestones over a period of time following closing, the seller is entitled to receive additional purchase price payments. This mechanism is attractive to sellers who have confidence in the long-term value of their business and want to be compensated for that value; earnouts are equally attractive to buyers who want to ensure they are getting what they pay for.

In the public company context, it is harder to find mechanisms to bridge valuation gaps between buyers and targets. One traditional method has been for the buyer to offer its stock as all or part of the consideration package to allow target shareholders to share in the upside of the combined company. However, that is not always an attractive alternative for target shareholders who may not want to be subject to the uncertainty associated with the buyer's stock, including fluctuations in the price between the signing and closing of the transaction. To solve this problem, collar mechanisms can be employed. With a collar, target shareholders receive additional cash or shares of the buyer if the trading price of the buyer's stock declines between the signing of the transaction and closing, or in some cases, during a period of time after closing.

Buyers and public company targets are also finding innovative structures to resolve uncertainty in the value of the target's business in much the same way that earnouts do in the private company context. Contingent value rights (CVRs) give target shareholders a right to receive additional consideration if a specified milestone or threshold is achieved in the future. That payment can be a fixed amount or can vary according to a specified formula. CVRs have become fairly common in the pharmaceutical sector when the future value of a particular drug is highly uncertain and contingent on events such as regulatory approval or the outcome of a clinical trial. A CVR can be used to provide additional consideration to target shareholders if the drug achieves specified milestones. CVRs have also been used in other contexts, such as where the outcome of significant litigation is uncertain, allowing target shareholders to share in a successful result.

Given the more widespread acceptance of the CVR structure in the pharmaceutical industry, we expect to see this structure used more frequently in other sectors. CVRs are complex and raise a host of legal issues, including issues related to transferability and ongoing public reporting requirements under Canadian or U.S. securities laws if the CVR is considered a "security," as well as tax and accounting issues. Care must also be exercised in the negotiation and drafting of the milestones and payment calculations under CVRs. Earnouts have historically been viewed as being prone to disputes and litigation as a result of differing interpretations of accounting formulas, or buyers manipulating outcomes to avoid or minimize the cost of an earnout. However, if properly structured, CVRs could provide the missing piece to getting the deal done.

As CVRs become more commonplace in other industries, there will be added pressure to develop payment triggers and formulas that are easily determined and quantifiable, as well as covenants to ensure that the buyer is not motivated to manage the business to deliberately avoid triggering a CVR payment.

$1.6 Billion Acquisition of Paladin Labs by Endo Health Solutions

Torys acted as Canadian counsel for Endo Health Solutions Inc. in its proposed acquisition of Paladin Labs Inc. A **one-way collar was used to protect target shareholders** against declines in the buyer's stock price. Paladin's shareholders will receive a combination of cash and stock for their shares. The cash portion will be increased **if Endo's stock price declines within certain parameters** during the reference period prior to the shareholder meeting. The total cash amount payable by Endo under the deal could **increase by as much as US$233 million** as a result of the collar.

How Would the One-Way Collar Work?

Endo stock price collar parameters during reference period:

↓7%–20%

Cash compensation to shareholders on a dollar-for-dollar basis

↓20%–24%

Cash compensation to shareholders on an incremental 50% basis

↓<24%

No further cash compensation

Shareholders who agreed to support the deal could terminate their voting support agreements

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Trending Approaches to Secure Valuation

Trend	How it works	How it helps
Contingent value rights	Buyer agrees to pay part of the purchase price conditional on the occurrence of future events	Can reconcile pricing differences between the parties if a future contingency is likely to affect the target's value
Collars	A contractual mechanism that protects against significant fluctuations in the buyer's market share price between signing and closing	Can mitigate market risks if the consideration paid by the buyer includes shares
Earnouts	Part of the purchase price is calculated by reference to the target's performance post-closing	Protects the buyer from overpaying for the target and compensates sellers who have confidence in the longer-term value of their business

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3 HOW FAIR IS FAIR? THE SPOTLIGHT WILL BE ON THE M&A SALES PROCESS

Sharon Geraghty, James Scarlett, Scott Cochlan

As M&A activity revives in 2014, we expect to see greater focus on building a sales process that establishes fairness and satisfactory price discovery. One clear marker of this trend is the increased frequency with which target boards obtain two fairness opinions: one from the company's adviser on the transaction and the second from an independent firm whose compensation is not tied to deal success, and which acts for the board or its special committee.

Market participants continue to debate the value of a second, independent opinion. Concerns are sometimes expressed that the independent adviser typically has not been close to the negotiations and therefore may be at a disadvantage in assessing the deal or might slow down the sales process and add to transaction costs. Set against these concerns is the view often expressed by board members that there is considerable value in an opinion that is independent of the success or failure of the proposed transaction. It is important to remember, however, that one approach does not fit all deals. The incremental value of an independent opinion can vary depending on the circumstances of the deal. For example, how significant is the transaction adviser's success fee? Was an effective market check on price conducted before the deal was signed? How serious are the conflicts of interest of board members or within the management group? What is the level of M&A experience at the board and management levels? Is there an effective post-signing procedure to perform a market price check?

Buyers have sometimes obtained fairness opinions when issuing significant share consideration. Although the buyer's board must consider the fairness of any transaction to its own stakeholders, it is rare to obtain a formal fairness opinion, particularly if the value of the consideration is transparent. However, when there is substantial share consideration, the buyer's board must also consider the potential dilutive impact on the buyer's shareholders and may be required to obtain shareholder approval of the share issuance. Obtaining an opinion can help explain the deal to shareholders and acts as a discipline and a shield against attack.

Although obtaining a fairness opinion offers evidence of reasonable board governance, the trend toward enhanced sales processes is also taking place at a more nuanced level. Boards are becoming engaged at an earlier stage, meeting more frequently and supervising management's negotiations more closely, especially where conflicts of interest are prevalent. We anticipate that this will continue, with directors and their legal and financial advisers more rigorously challenging the sales process, the validity of the assumptions that support their adviser's financial analysis and the appropriateness of deal-protection terms in the circumstances.

These developments are the natural outcome of improved governance practices, shareholder activism (see article 6, Shareholder Activism Will Increasingly Influence M&A Governance Practices), more extensive disclosure and recent cases, particularly in the United States, where sales processes have been challenged. Delaware courts have held that there is no single blueprint for a reasonable board process, and their judges are knowledgeable about M&A transactions and scrutinize board actions in great detail. They have criticized boards for failing to adequately test the market and for waiving standstills before signing an exclusive deal. They have also questioned the financial adviser's discounted cash flow analysis, management's negotiating tactics and the degree to which the board has supervised management.

Although Canadian courts tend to be more deferential, boards in Canada are facing greater scrutiny than in the past. Criticism of the sales process increases execution risk and jeopardizes reputations. With the continuing increase in U.S.-based shareholder activism and cross-border M&A, we expect Canadian boards to heed this trend and become similarly focused on establishing a robust sales process.

$5.1 Billion Hostile Takeover of Inmet Mining by First Quantum Minerals

Torys acted for Inmet Mining in connection with First Quantum's **unsolicited offer.** Torys advised Inmet on responding to First Quantum's initial proposals and subsequent offer, including **seeking strategic alternatives and engaging in defensive tactics** to enhance value for Inmet's shareholders. Inmet shareholders ultimately accepted First Quantum's **final offer,** which was **15% higher** than its initial proposal.

Value of First Quantum's proposal from October to December 2012

$4.3BN

$4.9BN

$5.1BN

Inmet-First Quantum Takeover Timeline

October 2012 First Quantum's initial proposal is valued at $4.3 billion. After reviewing it and receiving advice from its financial and legal advisers, Inmet declines the first proposal.

November 2012 First Quantum makes a revised proposal valued at $4.9 billion. Inmet declines the second proposal and implements a shareholder rights plan.

December 2012 First Quantum announces its intention to make an offer for Inmet, valued at $5.1 billion. Inmet establishes a special committee to review the offer.

January 2013 First Quantum makes a formal offer for Inmet. Inmet's directors recommend that shareholders reject First Quantum's offer.

February 2013 Inmet waives its shareholder rights plan and grants First Quantum access to Inmet's data room. After First Quantum's offer is extended several times, it acquires control of Inmet in March 2013.

A Good M&A Sales Process Will Include These Key Elements

Ask the Right Questions
Consider the interests of all relevant stakeholders

Make Unconflicted Decisions
Consider the formation of a special committee

Make Informed Decisions
Obtain advice and, if appropriate, a fairness opinion

Ensure Due Deliberation
Take adequate time to consider potential transaction

Keep Good Records
Prepare minutes and record advice

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4 FIDUCIARY OUTS ARE BROADENING

Patricia Koval, Andrew Gray, Janan Paskaran

In Canada and the United States, it has long been typical for targets to be prevented from soliciting competing proposals through "no-shop" and "no-change-in-recommendation" covenants – but these covenants are often subject to a number of qualifications, the most significant of which are "fiduciary-out" provisions. Fiduciary-out provisions give a target board the right to accept a superior proposal or otherwise change its recommendation to shareholders in order to get out of the deal with the acquiror. These provisions bring the parties' competing interests into play. While an acquiror wants certainty that the deal will be done even if an alternative proposal for the target is made, the target board wants to ensure that it can appropriately execute its fiduciary duties regarding the change-of-control transaction, including getting the most favourable deal for the securityholders. In both Canada and the United States, the trend is for target boards to press for broader rights to change their recommendations.

In the United States, target boards increasingly demand broader rights that allow them to change their recommendation to shareholders in light of an "intervening event" – usually defined as a material change that was unforeseeable when the agreement was signed (other than a competing bid). The use of this right typically allows for the possibility that the acquiror and target will attempt to negotiate mutually acceptable changes to their agreement in light of the intervening event. The acquiror will typically also have the option to terminate the agreement if the target board changes its recommendation before any shareholder vote and thereby receive a break fee. Acquirors will often seek to restrict the scope of "intervening event" provisions so as to limit the target's right to walk away from the deal. Exceptions to these provisions may include intervening events relating to the target's industry or economy as a whole, changes in the target's stock price, better-than-expected earnings or the timing of regulatory approvals.

"Intervening events" provisions may begin to appear in Canada, where we are seeing target boards increasingly seek greater flexibility within the terms of an acquisition agreement to change their recommendation to shareholders in the face of new information or changed circumstances. This is part of a broader trend toward more robust sales processes, which we discuss in article 3, How Fair Is Fair? The Spotlight Will Be on the M&A Sales Process. There are also provisions that permit the target to disclose information to shareholders in circumstances in which the target board, acting in good faith and upon advice, believes the same to be necessary for it to comply with its fiduciary obligations or applicable laws. These provisions are sometimes described as "backdoor fiduciary outs" – although the target board is not expressly permitted to change its recommendation except in limited circumstances where it pays a break fee, the disclosure may arguably permit a "backdoor" change in recommendation, allowing a target board effectively to encourage shareholders not to support the transaction without triggering a break fee.

The broadest form of fiduciary out would be for the target board to insist on the ability to change its recommendation in order to comply with its fiduciary duties. The board may negotiate an unqualified right, before shareholder approval of the transaction, to withdraw, qualify or change its recommendation if it determines, in good faith and after consultation with external advisers, that the failure to do so would be inconsistent with its fiduciary duties. In that case, the acquiror will typically have the option to terminate and receive a break fee. If provided in the acquisition agreement, the acquiror could force the target to hold the shareholder meeting despite such change in recommendation.

The scope of fiduciary-out provisions will continue to face scrutiny in court. The Delaware decision *In Re Compellent Technologies, Inc. Shareholder Litigation* is just one recent example of a long line of cases carefully examining the duties of target boards and the deal protection provisions utilized. In considering a settlement of that deal litigation, the Delaware Court scrutinized buyer-friendly no-shop and change-in-recommendation provisions in a merger agreement and found that, as originally negotiated, they had the effect of impairing the ability of the target board to obtain a higher price for shareholders.

As Canadian boards become more engaged on establishing robust sales processes, we expect that there will be greater focus in the upcoming year on the ability of target boards to exercise fiduciary outs.

How the Typical Fiduciary Out Works

Notice

- If the target receives a superior proposal, it must notify the acquiror, which will have the right to match the competing offer.
- Usually notice will be given within 24 hours.

Matching Period

- Typically, the matching period will be three to five days.
- The matching period is normally continuous (i.e., the acquiror will have the right to match each subsequent offer made).

Termination

- If the acquiror does not match the superior proposal, the target can terminate the purchase agreement, subject to paying a break fee.
- If the acquiror matches the superior proposal, the purchase agreement remains in place.

A Fiduciary Out Lexicon

1

No Shop.

This provision restricts the ability of the target board to look for alternatives to the negotiated deal. While the purchaser will want to limit the target board as severely as possible, the board will look to ensure that it has the flexibility to consider unsolicited approaches and may even seek the right to look for alternatives for a period of time (a "go-shop" provision).

2

Intervening Events.

A target board will want to ensure that it has some latitude to change its recommendation that shareholders vote in favour of a transaction, including if some event has occurred post-signing that affects the assessment of the bid. A purchaser will seek to narrow as much as it can the range of intervening events and the ability of the target board to change its recommendation.

3

Force the Vote.

A purchaser will want the target to hold a shareholder vote on its deal, even if the target board changes its recommendation to shareholders. A target board may be concerned that this provision will deter competing bids.

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5 BUYERS WILL FIND NEW WAYS TO GAIN AN EDGE IN PRIVATE COMPANY AUCTIONS

Richard Willoughby, Matthew Cockburn, Neville Jugnauth

Competition for proprietary deals, coupled with the availability of private equity capital, has led to increasing numbers of financial buyers participating in organized sales processes to originate deal flow. Prospective buyers in competitive auctions for private companies continue to push the boundaries to achieve an advantage in this environment – a trend we expect will continue in 2014.

On the buy-side, every competitive auction appears to be attracting a significant number of private equity firms, especially U.S.-based firms. The U.S. firms and their Canadian competitors are increasingly using industry specialization to differentiate themselves – not just through research, but often through investments in sector-specific companies and, in some cases, through establishing in-house operations teams. The result is that these financial buyers can match strategic players with deep industry insight and, with this confidence, they are often prepared to bid up the price or accept more post-closing risk. These new hybrid financial/strategic buyers are squeezing out other private equity firms without the same specialization and are competing more effectively against strategic buyers. Since they are also better positioned to partner with other industry players, make ambitious business plans more realistic and provide greater value through strategic planning and operational improvements, they can ultimately support higher purchase prices for businesses.

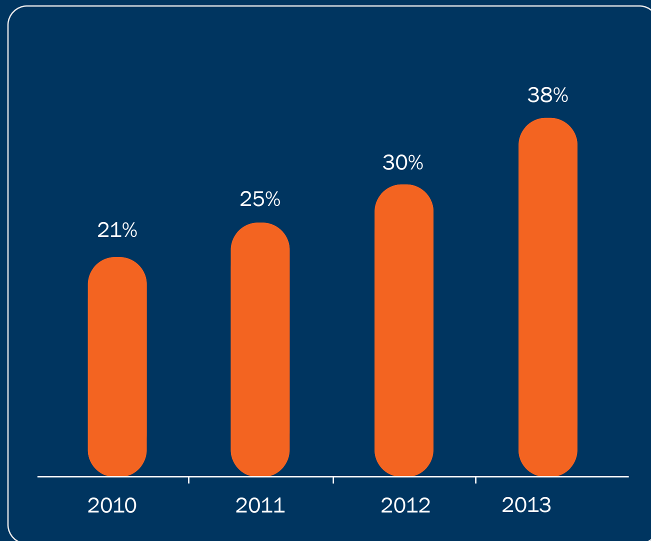
Timing and certainty of closing are other factors that potential buyers are using to differentiate themselves in a competitive bidding environment. A firm with industry expertise and a strong track record of closing deals and creating value in the relevant sector can increase a seller's confidence in that firm's bid in terms of both the bidder's ability to execute the transaction and its ability to carry the business forward post-closing. This will be particularly important to sellers rolling a portion of their equity into the acquired business. Firms planning a combination with an existing investee company have the added advantage of third-party financing sources already in place, which usually increases certainty and reduces the time to closing. Sellers are also working to improve the efficiency of the bid process and ensure the completeness of bids submitted during the auction. They are, for example, prepackaging key due diligence matters to fully educate buyers on inherent risks associated with the business being sold and to facilitate timely bids that are less conditional on, or subject to, price renegotiation pending due diligence review.

In some circumstances, buyers have attempted to gain a timing advantage by pursuing transactions on an immediate "sign-and-close" basis, without an interim pre-closing period that would ordinarily be used to obtain regulatory approval of the deal. Efficient sign-and-close transactions require a preliminary determination that regulatory approval is perfunctory. Buyers that have arrived at that assessment may initiate the regulatory process at their own cost in advance of a signed deal to allow for immediate signing and closing of the transaction once regulatory approval is obtained. This approach also helps avoid unnecessary friction with management that may come from negotiating a suite of interim operating and other protective covenants designed to safeguard the buyer's interest in the transaction pending closing.

Some prospective buyers are also seeking to increase their chances at successful bids through representation and warranty insurance. A buyer can purchase a policy to cover indemnity claims for breaches of representations and warranties in a purchase agreement. This coverage is relatively inexpensive – typically a one-time premium of 2% to 3% of the coverage. Without reducing the buyer's indemnification coverage, the insurance allows a buyer to reduce its indemnification demands on a seller, including reducing the need for a portion of the sale proceeds to be held in escrow. It has the added benefit of preserving goodwill with management by reducing the need for buyers to possibly pursue claims against sellers, who often remain on the management team after the change of ownership.

Although representation and warranty insurance has been available for many years, interest in the coverage is growing. This tool, along with the specialization of financial buyers, and prospective buyers' focus on tightening timing and the closing certainty on transactions, will affect private company auction dynamics in the year to come.

Canadian M&A Activity Over $100 Million Involving a Financial Buyer



Source: S&P Capital IQ

The availability of private equity capital has led to the growing participation of financial buyers in M&A sales processes.

While strategic players still continue to dominate the market, there has been a steady rise in the number of acquisitions by financial buyers of Canadian targets since 2010.

Top Five Contexts in Which Representation and Warranty Insurance Can be Useful

1. Seller wants limited or no exposure to unknown risks that could give rise to post-closing claims by the buyer.
2. Seller is a private equity or passive financial investor and is reluctant to provide an indemnity based on management's disclosure under the purchase agreement.
3. Buyer is concerned that the seller has inadequate creditworthiness to honour its indemnification commitment and the insurance is an alternative to an escrow.
4. Buyer does not wish to pursue an indemnification claim against the seller for business reasons.
5. Seller requires all the deal proceeds immediately, rather than placing a portion in escrow. Escrow delays the return of capital by a private equity seller to investors and negatively affects its return on investment.

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6 SHAREHOLDER ACTIVISM WILL INCREASINGLY INFLUENCE M&A GOVERNANCE PRACTICES

Michael Siltala, Patrice Walch-Watson, Cornell Wright

Few would dispute that shareholder activism has been growing in the United States and in Canada over the last few years. We see that trend continuing in 2014. More interesting, though, is that shareholder activism is on the verge of becoming mainstream. More public companies are expecting to encounter activism and are proactively preparing for it. This is affecting the boardroom.

Public company board governance practices are continuing to evolve as a consequence of increasingly restive investors. In the M&A context, activism is influencing governance in several ways:

Increased role for independent directors. Boards are more active than ever before. Independent directors are finding themselves at the centre of the action. Developments in the law are encouraging independent directors to play a leading role to guard against conflicts. In many cases, the board chair or lead independent director actively participates in negotiating transactions along with the CEO, a trend we discuss more broadly in article 3, How Fair is Fair? The Spotlight Will Be on the M&A Sales Process. In other cases, a special committee is formed to oversee the negotiations. Activist investors welcome this trend because independent directors are very mindful of their fiduciary duties and are often more open to considering ideas and plans that management may resist.

Shareholder votes influencing directors. Activists are using the threat of voting against directors as a way to get the board's attention. Majority voting policies enable shareholders to express their dissatisfaction with the board's performance on governance, but also on broader strategic questions. The prospect of receiving even a small number of "withhold" votes is one most directors prefer to avoid. Say-on-pay votes, which are becoming more common, provide shareholders with similar leverage. Although notionally about compensation, these votes also allow shareholders to express their views on the company's strategy, including matters such as returning capital to shareholders or M&A activity.

Board renewal. Board entrenchment is a major focus for activist investors, who look to independent directors to address failing or unresponsive management. When investors are unable to get traction for their ideas, they press for the rotation of directors in the hope of securing a more receptive audience. There are many examples of board renewal leading to a significant change in strategy or even to the sale of the company.

Shareholders asserting themselves on strategy. Investors are showing less deference to management and the board on strategy and are instead putting forward specific plans that often include divestitures. In many cases, investors are spending significant resources to come up with a comprehensive strategic plan, forcing the company's management to defend its own strategy. In one high-profile case, a company's major shareholders forced an overhaul of the company's board and the appointment of a new CEO when they determined that a new strategy was required following a failed takeover attempt.

Compensation arrangements. We expect that compensation issues, which are attracting significant attention generally, will receive more attention from investors in the context of M&A. In M&A transactions, decisions must be made about which directors and executives will stay or go. Compensation arrangements for those who remain and those who are terminated are also often negotiated or modified as a transaction is being negotiated. Conflicts in this area are difficult to manage because the affected individuals are the decision makers in the negotiations. We have seen special arrangements for executives become a focus for investors in the context of transactions. New rules adopted in the United States in response to Dodd-Frank require companies to provide enhanced disclosure of "golden parachute" compensation arrangements and to hold a separate shareholder advisory vote in the context of a merger transaction. Increasingly, we see deals being structured in ways to prevent significant bonus and retention payments from derailing them.

Examples of Shareholder Activism in 2013

Rona

September 16, 2012

Lowe's abandons takeover attempt

November 9, 2012

CEO resigns

November 14, 2012

Investors threaten proxy battle to replace board

December 6, 2012

Rona announces reassessment of strategy

January 21, 2013

Rona strikes deal with investors for board overhaul

Barrick Gold

April 19, 2013

Investors announce intent to vote against say-on-pay

April 24, 2013

85% of shareholders vote down say-on-pay

September 17, 2013

Barrick annouces compensation and governance review

December 4, 2013

Barrick announces Peter Munk's retirement and board shake-up

Talisman Energy

October 7, 2013

Carl Icahn discloses 6% stake

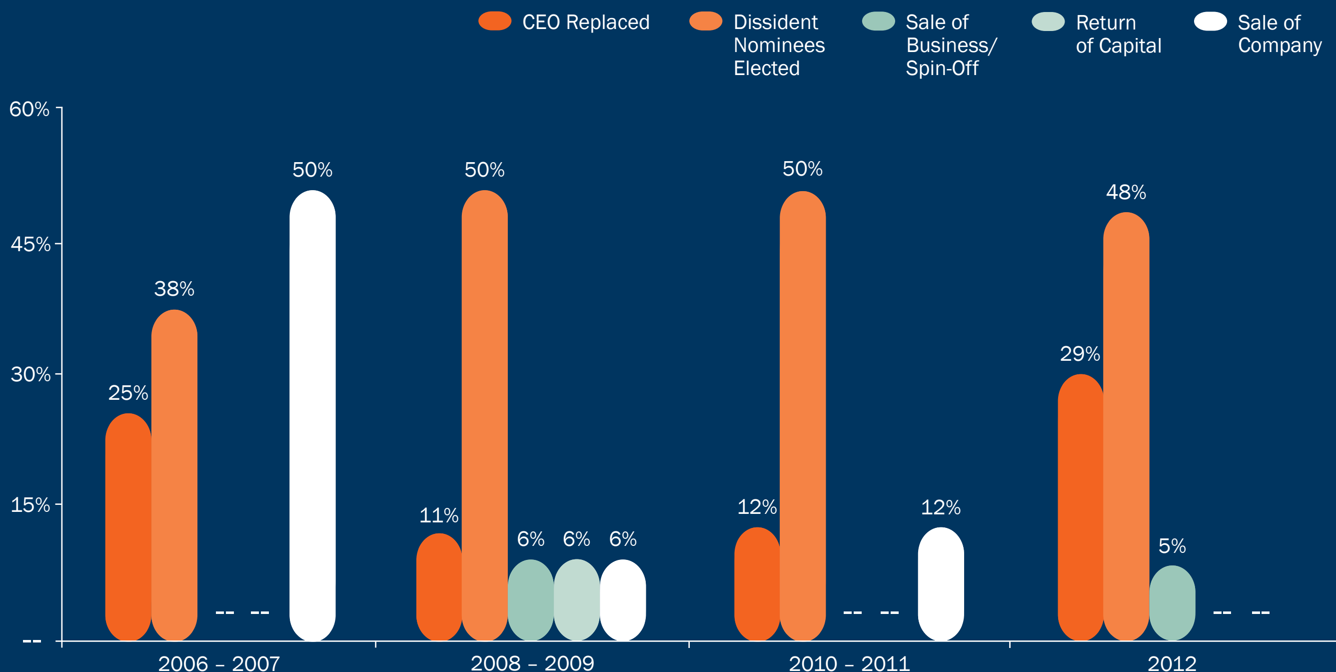
November 6, 2013

Talisman confirms preliminary talks with Icahn

December 2, 2013

Talisman appoints two Icahn representatives to board

Activist Campaign Outcomes In Canada*



Source: Bank of America Merrill Lynch

*Percentages represent the frequency of the corresponding outcome relative to the total year's campaign. Reflects only campaigns that have been settled or resolved.

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7 ACQUISITION FINANCING IN CANADA WILL TAKE CUES FROM THE UNITED STATES

Adam Delean, Kevin Fougere, Jonathan Wiener

Canadian banks spent 2013 bemoaning the competitive state of the market. A combination of sluggish M&A activity and an aggressive pursuit of Canadian deals by U.S. lenders has resulted in a number of significant trends that will shape Canadian acquisition financing activity in 2014.

The lion's share of M&A activity in Canada in 2013 had a private equity component. In many cases, this involved U.S. sponsors bringing their U.S.-market experience and expectations to bear. Canadian banks financing these acquisitions have been pressured to incorporate U.S. terms that were once foreign to them. These banks are now accepting U.S. approaches far more than they have in the past. For example, U.S. *SunGard* provisions are now common in Canadian commitment letters. These provisions limit the representations which are a condition to the financing to those representations which are required for the acquisition closing (with some additional narrow representations regarding the legal status of the borrower and loan documents). Canadian banks have also become more amenable to material adverse change (MAC) conditions consistent with those in the underlying acquisition agreement itself. This means that an unforeseen event permitting a prospective buyer to terminate the potential acquisition could equally allow the lenders to withdraw from the related financing commitment.

Despite Canadian lenders warming to a U.S. approach in loan documentation, some U.S. terms are still met with resistance. For example, U.S. *SunGard* provisions also limit the collateral requirements on closing to financing statement filings, delivery of possessory collateral (such as share certificates) and sometimes intellectual property filings, with other requirements pushed to after closing. Generally, this approach has not been used much in the Canadian market. Canadian banks are also not receptive to equity cures for financial covenants (equity cures permit sponsors to treat new equity investments as EBITDA, curing a financial covenant breach). Although equity cures have made occasional appearances, they are still rarely seen in the Canadian syndicated market. Canadian banks are similarly resisting "covenant lite" deals, which impose no financial covenants on the part of the borrower and which are a staple of the U.S. acquisition finance market.

Separately, the Canadian high-yield market is maturing, following the U.S. model. While the Canadian equity markets have been soft, the Canadian high-yield market has been active, particularly in the oil and gas sector. High-yield bonds are now an established financing option in an M&A context. A recent example of a high-yield offering used to finance an acquisition was Canadian Energy Services & Technology's issuance of senior unsecured bonds, which were primarily used to repay a bridge facility that was part of the acquisition. The limited size of the investor base in the Canadian high-yield market remains a consideration. Issuers may therefore need to be prepared to tap the deeper and more active U.S. high-yield market as an alternative if a high-yield offering is used to finance an acquisition in choppy markets or if the acquisition is of significant size.

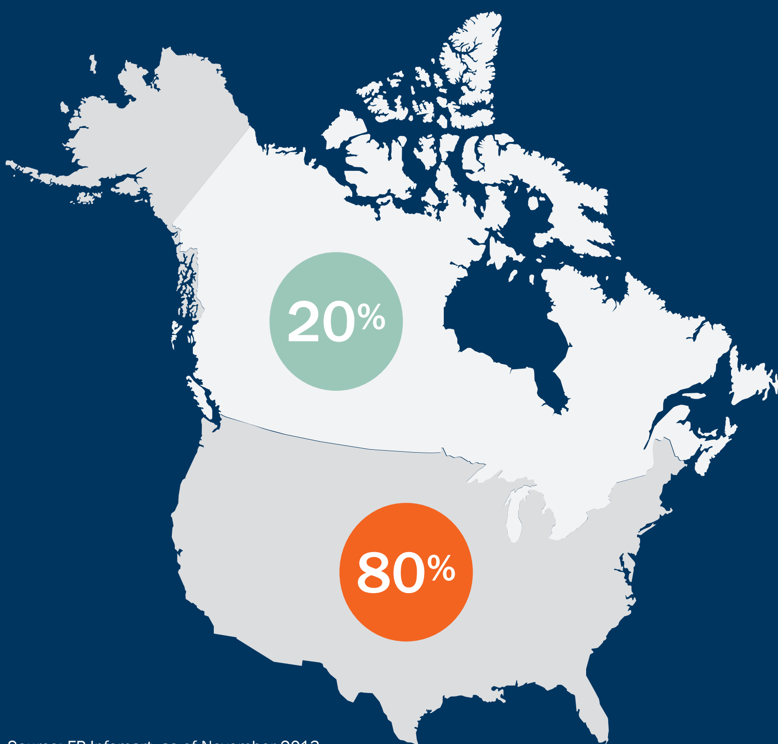
The soft Canadian equity markets have also encouraged acquirors to become more creative, especially in the oil and gas industry, to bridge the large gap between the buy and sell prices of assets or companies put on the market. These innovative pricing mechanisms are part of a broader trend that we describe in article 2, Contingent Value Rights and Similar Tools Are Becoming More Commonplace. Many potential sellers have assets that require large amounts of capital spending, and with less equity available, companies are financing their capital programs by selling portions of their assets through joint ventures. The buyers are deep pocketed, but tend to be passive and usually foreign investors. For these deals, the financing is driving the sale rather than the other way around. There is no lack of creativity in how these deals are being structured in terms of reversion rights, minimum returns and governance – and their popularity is clearly growing.

This latest trend in innovative financings, together with the growing influence of U.S. private-equity-backed transactions and the burgeoning Canadian high-yield market, will continue to affect the nature of M&A acquisition financing in Canada in the coming year.

Canadian Energy Services' Purchase of JACAM Chemical's Business Assets

Torys represented Canadian Energy Services & Technology Corp. in its cross-border acquisition of JACAM Chemical's production and specialty oilfield chemical business and subsidiaries. The **total purchase price of US$240 million** included the issuance of US$60 million in common shares of Canadian Energy Services to JACAM. **Related to the transaction was Canadian Energy Services' high-yield debt offering** that was used to indirectly fund the acquisition. Canadian Energy Services successfully raised **$225 million through the offering of high-yield seven-year bonds.** A portion of the net proceeds of the bonds was used to repay a bridge loan facility that was drawn on to complete the JACAM acquisition.

Canadian High-Yield Debt Market in 2013



Source: FP Infomart, as of November 2013

The Canadian high-yield debt market is maturing, following the U.S. model. However, given the limited size of the investor base in Canada, Canadian issuers continue to access the deeper and more active U.S. high-yield debt market.

In the past year, Canadian issuers raised 80% of their high-yield debt in the United States and the remaining 20% in Canada.

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8 SOME M&A DEALS WILL TAKE LONGER TO CLOSE— BUT MOST WILL NOT

Jay Holsten, Stefan Stauder, Derek Flaman

Some commentators have recently suggested that M&A transactions are taking longer to complete because antitrust and other regulators are more closely scrutinizing deals or are becoming more activist. We believe these concerns are overstated.

On the competition front, it is true that some recent merger transactions have faced relatively long reviews. However, we believe that the review timelines in many of these cases reflect the inherent complexity of the transactions, rather than a more interventionist approach by competition regulators.

Consider this: over the past five years, the average time for Canada's Competition Bureau to complete reviews of mergers that triggered the issuance of a supplemental information request (SIR) – typically, the transactions that raise the most significant merger issues – has actually dropped by nearly one-third, from more than seven months in 2009 to just over five months in 2013. An important driver of this trend has been increasing reliance by both the Bureau and deal counsel on technology designed to speed up document production. We expect that as predictive coding – a technology that automates many of the time-consuming aspects of document review – gains acceptance in merger review, further timing efficiencies will be achieved.

The Bureau is also taking a more pragmatic approach to merger review than it has in the past, particularly in those industries with which it has extensive experience. It recently scaled back the information that it requires from merging parties in connection with its review of upstream oil and gas transactions, and it is examining other areas in which review efficiencies can be achieved.

Controversial and complex foreign investment reviews made headlines in 2013, as they have for the past several years. However, for the most part, the limited information available suggests that median review times under the *Investment Canada Act* have not increased much, if at all, over the past five years.

In the United States, M&A transactions are, for the most part, also facing fewer timing hurdles. For example, between 2011 and 2012, the number of merger reviews in which a second request was issued by U.S. antitrust authorities decreased by more than 10%, and the incidence of early termination of the initial 30-day statutory waiting period increased by 5%. The limited information available on CFIUS filings is a bit harder to parse, but it does not suggest that regulatory concerns are causing more timing delays than in previous years.

While the large majority of North American M&A transactions now clear the competition and foreign investment review processes faster than similar transactions did just a few years ago – a trend that we expect will continue – there will be exceptions. Two main categories stand out.

The first category involves strategic transactions between major competitors – such as American Airlines' acquisition of US Airways – which will continue to face rigorous competition reviews. Reviews of these transactions will take even longer when they involve markets that are inherently complicated to assess or with which competition regulators have little prior experience. In Canada, several of the Competition Bureau's most complex recent transactions have been retail mergers, which typically involve numerous markets in which competitive effects must be assessed.

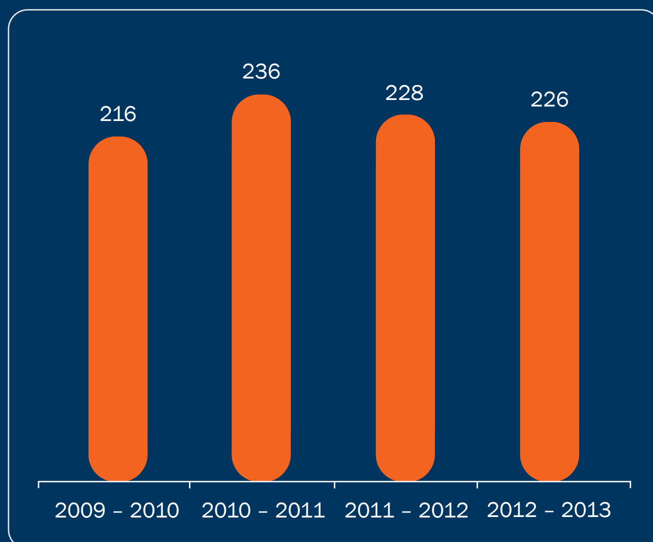
The second category involves controversial foreign investment transactions. In both Canada and the United States, we expect that transactions involving state-owned enterprises, "strategic" assets or those that otherwise give rise to national security concerns will remain outliers in terms of both review timing and outcome. Recent reviews suggest that, timing issues aside, the Canadian and U.S. governments are becoming more skeptical about certain types of foreign investments.

Entertainment One's Acquisition of Alliance Films, Inc.

Torys advised Alliance Films and Goldman Sachs in the $225 million sale of Alliance Films. The transaction combined **Canada's two independent film distributors** and was subject to the Competition Bureau's in-depth review. In response to the Bureau's SIR, Alliance produced **350 GB** of data and over **100,000 documents** – in less than one month. Torys managed 120 contract lawyers working in 12-hour shifts, seven days a week. The quick document review, and the Bureau's able and experienced case team, resulted in the deal being **cleared without remedies in less than four months.**

Merger Caseload

The Competition Bureau's merger caseload has remained relatively steady over the past few years.



Source: Competition Bureau, Merger Notification Unit Report, May 2013

Merger Review Times

Merger review times involving SIRs have dropped by nearly one-third since 2009.

Source: Competition Bureau, October 2013

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9 RESOURCE COMPANIES WILL FOCUS ON CAPITAL EFFICIENCIES

Michael Amm, Stephanie Stimpson, Kevin Morris

The downward trend in the commodity cycle for mining companies and sustained low natural gas prices have created acquisition opportunities for firms with access to capital. Major corporations in the resource sector are looking at divestitures and other opportunities to achieve efficiencies, strengthen core operations and position themselves for profitability. Both their continued focus on capital efficiencies and the favourable investment prospects for other market players are major trends that we expect to see in the resource sector in 2014.

In the mining sector, lower commodity prices, uncertain demand growth from China, high operating costs and the need to reduce debt are ongoing challenges that have prompted significant divestitures by the larger global mining companies. These divestitures are likely to continue as major players prioritize profitability over resource growth. Prominent examples include Rio Tinto's proposed or completed pruning of aluminum, copper, iron ore and diamond assets around the world and Barrick Gold's disposal of its energy business and gold mines in Australia.

Disposals by the major miners have created opportunities for mid-tier companies to acquire strategic assets – Capstone Mining's US$650 million purchase of the Pinto Valley copper mine from BHP is one example. Attractive assets have drawn large-scale interest in the mining sector from private equity players and certain Canadian pension plans, with their presence seen in various sale processes of the major miners. A similar phenomenon is occurring in the oil and gas sector. Continued weak natural gas prices and relatively stable oil prices have been catalysts for M&A activity for many Canadian oil and gas players, with deals directed at raising capital to strengthen balance sheets and focus on long-term strategic assets. Many of these deals have been conducted in tandem with shake-ups in executive groups and under the banner of new leadership. The junior oil and gas sector, in particular, has been hit hard by the lack of capital, deeply discounted stock prices and expensive debt, preventing properties from proving up and generating cash flow.

Higher well costs and more technical drilling programs have seen the capital needed for many of the new plays increase from tens of millions to hundreds of millions of dollars. Oil and gas players have turned to Canadian and U.S.-based private equity firms that have (or are developing) deep industry specialization to gain a competitive advantage as buyers of these assets – a trend we discuss in article 5, Buyers Will Find New Ways to Gain an Edge in Private Company Auctions. While capital is available for recognized management teams with the right assets, completing transactions remains challenging as prospective buyers scrutinize deal metrics and the ability of assets to deliver value. For those without the luxury of time in this buyer's market, persistent low gas prices and a lack of capital have led to discounted asset sales.

The need for capital will continue to drive alternative financing, such as joint ventures and streaming and royalty transactions. Although joint ventures offer an innovative way to bridge large valuation gaps in the oil and gas sector (e.g., the joint venture by Bellatrix in 2013; also see article 7, Acquisition Financing in Canada Will Take Cues From the United States), recent Canadian tax changes may lead to sellers incurring greater tax charges (see article 10, Foreign Buyers Beware: The Taxman Cometh). Mining companies will seek joint venture arrangements to raise capital and share costs and risk on major development projects. Recent examples are Arcelor's restructuring of its interest in the Mary River Project and its sale of a 15% interest in ArcelorMittal Mines Canada for US$1.1 billion to a consortium led by Korea's POSCO and China Steel Corporation. We also expect continued use of precious metals streaming and royalty transactions to finance development projects.

A key obstacle to completing deals has been the pricing gap between value-driven purchasers/private equity players and vendor corporations. We expect that this gap will close as pressure builds on resource companies to complete divestitures, more alternative financing structures become available and private equity players build further expertise and confidence in the resource sector. Although 2014 is likely to be another challenging year, companies that focus on profitability in core operations and others who capitalize on acquisition opportunities at attractive valuations will be better positioned to perform and grow over the longer term.

ArcelorMittal's Restructuring of Its Joint Venture for the Mary River Project

Torys represented ArcelorMittal in the restructuring of its joint venture and offtake arrangements in connection with the Mary River Project in Nunavut. Nunavut Iron Ore, Inc., a subsidiary of Iron Ore Holdings, LP, increased its interest in this project by 20% and agreed to increase its share of funding for the development of the project. ArcelorMittal retained a 50% interest in the project as well as operator and marketing rights.

Disposals of Non-Core Assets in the Resource Sector

Major and mid-size players are shedding non-core properties; several prominent disposal processes took place in 2013.

Oil and Gas

Vendor	Strategy
Suncor	• Divested bulk of conventional natural gas business for $1 billion to focus on higher-return oil assets
Pengrowth Energy	• Disposed of roughly $1 billion worth of non-core assets to fund development of Lindbergh oilsands project
Talisman Energy	• Disposed of Montney natural gas assets for $1.5 billion, relinquished assets in several jurisdictions and plans to sell $2-$3 billion in assets by mid-2014
EnCana	• Sold certain legacy assets and Kitimat LNG stake, and entered into a joint venture with PetroChina; intends to focus on five key oil-and-liquids-rich resource plays and IPO Clearwater assets and royalty business
Penn West	• Intends to focus on development in light oil assets with $1.5-$2 billion worth of disposals planned to repay debt

Mining

Vendor	Highlighted Sale Processes
Rio Tinto	• Proposed sale of majority interest in Iron Ore Company of Canada • Sold Northparkes copper mine in Australia to China Molybdenum for US$820 million • Sold Eagle nickel/copper mine in Michigan to Lundin Mining for US$325 million
BHP Billiton	• Sold diamond business to Dominion Diamond Corporation for US$553 million • Sold Pinto Valley copper mine in Arizona to Capstone Mining for US$650 million • Sold stake in the Browse LNG project in Australia to PetroChina for US$1.6 billion
Barrick Gold	• Proposed sale of stake in African Barrick • Sold Canadian energy assets to Venturion Oil, Whitecap Resources & Canadian Natural Resources for C$455 million • Sold Yilgarn South assets in Australia to Gold Fields for US$270 million

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10 FOREIGN BUYERS BEWARE: THE TAXMAN COMETH

Corrado Cardarelli, Jerald Wortsman, Craig Maurice

Recent and proposed Canadian tax law changes will affect tax planning and structuring matters for cross-border and international transactions. The Canadian tax authorities have tightened tax rules on the use of partnerships as a favourable acquisition structure for foreign investors. New rules will also affect takeovers of Canadian targets and may make it more difficult to use bilateral tax treaties for foreign investment in Canada. The bottom line is that 2014 could potentially cost foreign investors more – in tax dollars.

The first set of changes affects M&A transactions that involve a transfer of an interest in a partnership. Tax rules have been significantly reinforced to expand the circumstances in which an interest in a partnership will be considered to be transferred to a tax-exempt entity, such as a Canadian pension plan. The rules have also been extended to apply, with a few exceptions, to non-resident foreign investors. Normally, on a transfer of a partnership interest, only half of the vendor's capital gain realized on the transfer is treated as income. The rules relating to transfers to tax-exempt entities, which have now been extended to non-residents, are such that the vendor's entire capital gain may be treated as income, triggering a greater tax charge for the vendor. This will apply only if the direct sale of the partnership's underlying properties would have resulted in the partnership recognizing income that is not an ordinary capital gain.

These changes will need to be considered in structuring and determining the tax consequences of an M&A transaction implicating Canadian tax-exempt entities or non-residents. But the tax planning does not stop there – any joint venture set up as a partnership with these kinds of investors will also be affected. And while there may be, for example, economic benefits in forming an innovative joint venture to narrow pricing gaps between the buyer and seller (see article 7, Acquisition Financing in Canada Will Take Cues from the United States), the potential tax consequences of these venture structures should not be overlooked.

Related changes will also affect takeovers of Canadian targets by non-resident buyers using a Canadian acquisition vehicle. Foreign buyers have increasingly used partnership structures through which a Canadian target holds certain assets indirectly that the buyer wishes to reorganize within its corporate group. These assets, which may include inventory and resource property, are not directly eligible for a "bump." (A bump allows the foreign buyer to adjust the tax basis of the assets and distribute them tax-efficiently outside Canada.) Previously the target's interest in the partnership was eligible for the bump and could be transferred within the buyer's group in order to shift the underlying assets. The new rules close this planning technique and greatly limit the buyer's ability to obtain a bump in the tax cost of the partnership interest.

A foreign buyer of a Canadian target with substantial value tied to non-Canadian affiliates will also have to confront new foreign affiliate dumping rules. The rules could result in the erosion of cross-border paid-up capital (in the shares of the Canadian target held by the non-resident) or possibly in a deemed dividend payment by the Canadian target to the non-resident, when "investments" (a broadly defined concept) are made by the target in its foreign affiliates after the acquisition takes effect.

Finally, the government is consulting on initiatives aimed at restricting "treaty shopping." Treaty shopping generally refers to circumstances in which non-residents strategically structure their investments in Canadian entities through foreign jurisdictions that have beneficial tax treaties with Canada. Although the consultation process is in its early stages, the government appears to favour unilateral action by Canada through a domestic anti-avoidance rule that would deny treaty benefits to transactions in which the "main purpose" is improper treaty shopping.

These potential initiatives, together with the new tax rules on partnership transfers and foreign affiliate dumping, represent a variety of significant implications for foreign buyers who are planning and structuring acquisitions of, or investments in, Canadian entities in 2014.

Top 10 Countries Investing in Canada Averages 2006 – 2010

Top 10 Countries with the Highest Ratio of Foreign Direct Investment and Outbound Stocks*

Source: Government of Canada, "Consultation Paper on Treaty Shopping – The Problem and Possible Solutions", August 2013
*as a percentage of GDP averaged over 2006 to 2010 for 159 countries

Bump Planning for Partnership Interests

The Canadian tax authorities are shutting down bump planning as it relates to partnerships.

The Canadian target has assets, such as inventory, that are not directly eligible for the bump.

The foreign buyer uses a Canadian acquisition vehicle to acquire the target. A partnership is created to hold these assets. Bidco and Target amalgamate.

The partnership interest is transferred overseas to shift the assets. The foreign buyer's ability to obtain a bump is now restricted under regulation.

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TORYS' M&A PRACTICE

Torys' M&A Practice is highly regarded for its experience in sophisticated, complex and innovative mergers and acquisitions. We are involved in high-profile transactions, both public and private, for companies of all sizes. On cross-border and global M&A transactions, we provide seamless service to clients in the United States, Canada and internationally.

The members of our M&A Practice have the expertise to advise on all of the areas of law that pertain to M&A transactions, including corporate; securities; litigation and dispute resolution; competition and antitrust; taxation; foreign investment issues; regulatory matters, including stock exchange requirements; intellectual property; and employment, pension and benefits issues.

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