TORYS LLP

Arrangement Transactions in Canadian M&A

Whether for a public target or a private company acquisition, Torys breaks down the essential steps in an arrangement transaction for targets, boards and securityholders.

A Business Law Guide

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The purpose and scope of this guide

This business law guide is a general overview of certain legal and business matters that may be relevant to mergers and acquisitions carried out by way of an arrangement in Canada.

It is important to note that the information contained in this guide is accurate as of the date shown below.

Because the laws and policies of governments and regulatory authorities may change from time to time, some of the information may no longer be accurate when you read this.

In this guide, unless the context suggests otherwise, the term “a province” or “provinces” of Canada indicates also “a territory” or “territories” of Canada.

This guide of course does not encompass all the possible legal, business and other issues that may have an impact on or be relevant to an arrangement transaction. Since it is a general overview, this guide should not be regarded as either exhaustive in subject matter or comprehensive in discussion. It is not, therefore, a substitute for qualified, professional advice.

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Introduction

This guide focuses on Canadian M&A transactions structured as an arrangement. An arrangement is the most commonly used structure to acquire a Canadian public company target. An arrangement is typically used in a friendly, negotiated transaction and is not used in a hostile situation since the arrangement process is largely driven by the target rather than the acquiror. An arrangement involves a securityholder vote, unlike a takeover bid that involves an acquiror making an offer directly to target shareholders to acquire shares through a tender process. In a hostile situation, a takeover bid is the only way to acquire a Canadian target company. In a friendly situation, many variables will influence the choice of the best way to acquire a target. The most appropriate form of transaction will often become apparent during planning or negotiations and will depend on a number of factors, including how quickly the acquiror wants to gain control of the target, the tax implications of the transaction, the available methods of financing the transaction and regulatory hurdles such as antitrust review.

This guide focuses on the law governing corporate entities. An arrangement is a creature of corporate law under which the jurisdiction of the court to approve arrangement transactions is limited to corporations governed by the applicable statute. Nonetheless, because the arrangement is a well-understood transaction structure with benefits for targets, boards and securityholders, it may be used in respect of targets organized as trusts or limited partnerships. While those transactions often involve a step affecting a corporation, the court finds its broader supervisory and approval jurisdiction elsewhere (for example, for trusts under the Trustee Act).

This guide focuses on public targets, but it is not necessary that the target be a public entity. An arrangement could also be an attractive path to acquire private companies with complex capital structures or a large number of shareholders.

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The lay of the land

Overview

An arrangement is by far the most common way for a public company to be acquired in Canada. An arrangement is used in a friendly negotiated transaction only and is not a structure utilized in a hostile situation.[1] An arrangement requires target shareholder approval, typically at a threshold of not less than ⅔ of the votes cast at the meeting, but this is determined by the court. It also requires court approval following a "fairness" hearing. An arrangement is a very flexible way to acquire a Canadian company in that it allows the parties to deal with complex tax issues, amend the terms of securities (such as convertibles, exchangeables, warrants or debentures) and treat different holders of securities differently. Arrangements also provide acquirors with greater flexibility than takeover bids to deal with the target's outstanding stock options—for example, if an option plan does not include appropriate change-of-control provisions for accelerated vesting or termination. In addition, if an acquiror is offering securities to target shareholders as consideration and some of those shareholders reside in the United States, arrangement transactions have the added benefit of providing an exemption from the SEC registration and disclosure requirements that would otherwise apply to the issuance of such securities to US residents.

Friendly versus unsolicited transactions

A key variable in structuring any acquisition of a Canadian public company target is whether the transaction is friendly or unsolicited. Unsolicited transactions often result in a change of control either by the initial unsolicited bidder or a "white knight" acquiror. In an unsolicited transaction, the highest price usually wins.

In addition to the risk of failure associated with unsolicited deals, friendly transactions have historically been more desirable for the following reasons:

- In unsolicited transactions for a Canadian target, the target has a relatively long period of time (105 days) to evaluate and respond to an unsolicited takeover bid. The 105-day period increases deal uncertainty for an unsolicited bidder, exposing it, for example, to interloper risk.
- In unsolicited transactions, the target will actively solicit competing transactions and may take other actions to thwart the bid, such as attempting to negatively influence the granting of regulatory approvals, initiating litigation and taking other defensive measures that make unsolicited transactions more complicated and potentially more expensive.

[1] A takeover bid is the only way to acquire a hostile target because the offer is made directly to the target shareholders, thereby bypassing its management and board of directors.

- A friendly acquiror can obtain access to confidential information for due diligence purposes whereas, in an unsolicited situation, access is often not granted.
- A friendly acquiror can obtain the benefit of a “no shop” covenant, which prevents a target from soliciting competing offers (subject to a “fiduciary out”).
- A friendly acquiror may have the benefit of a break fee, expense reimbursement and the right to match competing bids (as the quid pro quo for the fiduciary out).
- To be successful, an unsolicited bidder may have to indirectly pay the break fee as well as the purchase price if the target has already agreed to a friendly transaction with a third party.
- Friendly transactions allow greater flexibility to structure a transaction to meet tax and other regulatory objectives.

Despite the advantages of friendly deals, it is sometimes necessary for a bidder to bypass an unwilling target board. The advantages of unsolicited offers for acquirors include the following:

- In an unsolicited transaction, the acquiror determines the initial bid price and the time of launching the transaction without having to negotiate with the target, whereas in a friendly deal, the target’s board may seek a higher price as a condition of making a favourable recommendation to target shareholders which may result in delay.
- An unsolicited transaction may avoid certain difficult management issues associated with mergers of equals, such as who will be CEO and how the board will be constituted.
- In an unsolicited transaction, there is less risk of rumours circulating in the market during confidential negotiations, causing a run-up in the target’s share price and potentially making the deal more expensive.

Advantages and disadvantages

Some of the relative advantages of proceeding by way of an arrangement, as opposed to a takeover bid, include the following:

- An arrangement is a one-step acquisition, which can mitigate financing and other risks for the acquisition.
- An arrangement may have a lower acceptance threshold than a bid because the threshold is set based on the votes actually cast by target shareholders, rather than the percentage of outstanding target shares tendered.
- An arrangement can be sequenced in multiple steps with precise timing to achieve desired tax and commercial objectives.
- An arrangement can address issues with outstanding stock options and warrants.
- An arrangement does not give rise to prohibitions on collateral benefits and pre-bid acquisitions like a takeover bid can.

- An arrangement may be conditional on financing (although, typically, a target board would require financing certainty prior to proceeding).
- An arrangement can be structured to address creditors.
- In a cross-border situation where there are U.S. resident target shareholders, an arrangement will not trigger U.S. tender offer rules since it is a voting transaction and not a tender process.
- Where securities of the acquiror are being offered to U.S. resident target shareholders as full or partial consideration in an arrangement, those securities may not have to be registered with the SEC due to the availability of the Section 3(a)(10) exemption under U.S. securities laws (which applies to a court approved exchange of securities), regardless of the magnitude of U.S. shareholdings.
- Where a U.S. acquiror uses its shares as full or partial consideration for a Canadian target, an arrangement is often the easiest way to create an exchangeable share structure that provides Canadian target shareholders with tax deferred (rollover) treatment.
- Once the arrangement has been approved as being fair and reasonable by a Court, the transaction can be more difficult for dissenting securityholders or other stakeholders to attack than might otherwise be the case.

Some of the relative disadvantages of an arrangement compared to a bid can include:

- The court process can be a forum for dissidents to challenge or delay the deal.
- An arrangement may be less flexible in terms of enabling the acquiror to respond to a competing bid or proposal should one arise.
- In an arrangement following signing of the arrangement agreement, the target controls timing, process and documentation, subject to contractual obligations, whereas a takeover bid is a process that is acquiror driven.

Business combinations

The term “business combination” is generally used to refer to an acquisition of a public company’s outstanding securities by a related party, such as an existing significant shareholder, members of management or an acquiror in which an existing shareholder (including one who has acquired 10% or more through a toehold) or management will have an interest. Because the acquiror is a related party of the issuer and public shareholders are being “squeezed out” of their equity interest, business combinations involve inherent conflicts of interest and inequalities of information. To protect public shareholders in these circumstances, Canadian securities laws prescribe heightened legal requirements when an arrangement is also a business combination. These rules are set forth in *Multilateral Instrument 61-101 – Protection of Minority Security Holders in Special Transactions (“MI 61-101”)*, in Ontario, Quebec, Alberta and certain other provinces.

For an arrangement that is subject to these rules, MI 61-101 generally requires:

- A formal, independent valuation of the target's shares and any non-cash consideration, the preparation of which must be supervised by an independent committee of the target's board.
- Heightened disclosure, including detailed disclosure of the background to the arrangement and any other valuations prepared or offers received for the target's securities in the past two years.
- Majority of the minority shareholder approval, in addition to the vote required under corporate law, excluding the votes of shares held by interested parties and related parties of interested parties and their respective joint actors.

In the context of private equity buyouts of public companies, the heightened legal requirements applicable to business combinations give rise to timing and process considerations. For example, if an acquiror provides management with a significant equity interest following the closing of the transaction (as is often the case if the acquiror is a private equity firm), the transaction will be a business combination and minority approval and a formal valuation may be required under MI 61-101.

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Pre-transaction issues

Insider trading

At the very outset of a potential transaction, a company's directors and any officers involved in the deal should be aware of their responsibilities under securities laws as insiders who possess material, non-public information. It is extremely important for both acquirors and targets to have comprehensive internal policies and procedures aimed at preventing insider trading, tipping or selective disclosure of material non-public information. Prevention is crucial because even third parties not directly involved in the transaction may face potential liability for improper trading or tipping, depending on the circumstances and the chain of communication of confidential information. The various prohibitions are set forth in section 76 of the *Ontario Securities Act* (and equivalent provisions of other Canadian jurisdictions).

Public disclosure about a deal

Public companies must keep the market informed of important corporate developments. In the context of M&A transactions, companies must reconcile the business advantages of keeping potential transactions confidential with the legal obligation to provide disclosure under securities laws.

Until a pending material transaction is announced, a company may not trade in its own securities (such as under a share repurchase program), except pursuant to an automatic share purchase plan, because that would amount to insider trading. If trading activity in a company's securities is unusually high or if rumours begin circulating about the company, a stock exchange may ask for an explanation and may compel public disclosure of any material information. In addition, companies may not actively mislead the market—for example, by falsely denying the existence of material news.

A company's public statements about a potential M&A transaction are subject to civil liability for material misstatements or omissions.

Acquiring a toehold

If not prohibited by securities law because of insider trading prohibitions, the potential advantages of acquiring target shares before proceeding with an acquisition transaction are:

- Market purchases may be made at prices below the transaction price, thereby reducing the ultimate cost of the acquisition.

- Acquiring a meaningful stake demonstrates the acquiror's commitment to the potential transaction and may be an advantage against competing acquirors in a contested deal.
- It may allow the acquiror to profit from a run-up in the target share price if a competing acquiror ultimately acquires the target.

A particular advantage of an arrangement versus a takeover bid is that, when acquiring a toehold, bidders in a takeover bid must comply with Canadian "pre-bid integration" rules. These rules require that: (i) the consideration paid in a formal offer be at least equal to and in the same form (e.g., cash or shares) as the highest price paid in any private transaction during the 90 days before the bid; and (ii) the proportion of shares sought in a formal offer be at least equal to the highest proportion of shares purchased from a seller in any such transaction. These rules are not applicable to an arrangement, which provides a greater degree of flexibility to an acquiror's pre-transaction structuring if an arrangement structure is utilized.

Pre-transaction purchases of shares of a Canadian target may be counterproductive because:

- A target may perceive a toehold acquisition as being an aggressive tactic, making it more difficult to engage the target in discussions.
- A toehold acquisition may increase the likelihood of a market leak as to the acquiror's interest in a deal.
- If a deal is not agreed to and no competing acquisition is completed, the toehold acquiror may be left with a stranded position.

Early warning disclosure

Any purchase of target securities before an arrangement transaction is commenced could trigger an early warning disclosure requirement for the acquiror. The Canadian early warning requirements apply to acquisitions of voting or equity securities of a target.

The disclosure requirement is triggered when the acquiror (including others acting together with the acquiror) crosses the 10% level in Canada. If a formal bid for the target is already outstanding, the threshold becomes 5%.

If the target is listed on both a Canadian and a U.S. stock exchange, the lower U.S. reporting threshold of 5% will apply and the acquiror will be subject to additional U.S. reporting requirements.

In Canada, the acquiror must promptly issue a news release by no later than the opening of trading on the next business day disclosing its future investment intentions and must file a report with securities regulators within two business days. The acquiror must halt purchases of the target's shares until one business day after the report is filed unless it already owns 20% or more of the shares. Given the obligation to halt purchases, the acquiror will want to purchase the largest single block of shares possible in crossing the 10% threshold. Material changes in the information on file with securities regulators or further acquisitions (or disposals) of 2% or more of the target's shares will trigger further disclosure.

Voting support agreements

Voting support agreements with major target shareholders to secure their positive votes at the required target shareholders meeting are common in arrangement transactions. Entering into a voting support agreement is an alternative to acquiring a toehold in the open market. Acquirors generally disclose the details of voting support agreements in the proxy materials delivered to target shareholders in an arrangement and file the agreements as material contracts.

An issue under Canadian law is whether a shareholder that enters into a voting support agreement with an acquiror to vote in favour of an arrangement will be treated as acting jointly or in concert with the acquiror. If so, the arrangement may be treated as a business combination under MI 61-101 requiring a formal valuation, and the shares may not be counted toward the majority of the minority approval requirement. However, the fact that the shareholder has entered into a voting support agreement with the acquiror, even if the agreement is irrevocable and broadly worded, will not by itself be sufficient to establish that the shareholder and acquiror are acting jointly or in concert. Generally, for a joint actor relationship to exist, there must be other circumstances beyond the voting support agreement, such as a prior or existing relationship between the shareholder and the acquiror or some other involvement by the shareholder in the planning or negotiation of the transaction.

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The rules of the road

Timeline

Please see Appendix A for an arrangement timeline.

The arrangement process

Statutory pre-conditions

There are a number of statutory pre-conditions that must be met in order for an arrangement to proceed. The court, in making an order approving an arrangement, must be satisfied that:

- The proposed arrangement qualifies as an “arrangement” under the statutory definition.
- The applicant corporation is not “insolvent”.
- Under some corporate statutes, it is also necessary for the applicant to establish that it is not “practicable” for the corporation to effect a fundamental change in the nature of the arrangement under any other provision of the relevant corporate statute.

Primary steps

Set out below is an outline of the primary steps involved in an arrangement, including the steps required for shareholder and court approval:

- Sign confidentiality agreement, typically with a standstill provision restricting the acquiror from launching a hostile transaction in exchange for due diligence access concerning the target.
- Negotiate and sign arrangement agreement, including the plan of arrangement and any voting support agreements (typically the transaction is publicly announced once the arrangement agreement is signed).
- Prepare proxy materials for the target shareholders meeting.
- Obtain interim court order.
- Mail and file target proxy materials.
- Hold target shareholders meeting.
- Obtain final court order at fairness hearing.

- File articles of arrangement under the relevant corporate statute to implement the arrangement.

Interim court hearing

The court approval process, which is central to an arrangement, involves a two-stage court proceeding commenced by the target: an interim court hearing at which the court sets the ground rules for holding the target shareholders meeting and other procedural matters and a final hearing at which the court will consider, among other things, the fairness of the arrangement. While the court has jurisdiction over the approval process, securities laws and securities regulators are also relevant.

The first stage for court approval of an arrangement involves a motion for an interim order brought by the target, without notice to its shareholders. As a result of contractual provisions in the arrangement agreement, the acquiror will typically have significant input into the motion materials and attend the hearing. The motion is heard after the parties have signed the arrangement agreement and substantially completed the proxy materials for the target shareholders meeting. In the motion, the target requests the court to grant an interim order that establishes the mechanics for shareholder and final court approval of the arrangement, reflecting the terms of the arrangement agreement and the requirements of the applicable corporate statute. The interim order, among other things:

- Will set the record date for the target shareholders meeting and the time and place of the meeting.
- Will provide for the timing and means of notice of the shareholders meeting and court proceeding to be given to the shareholders, directors and auditors of the target.
- Will fix the levels of shareholder approval needed for the arrangement.
- May provide dissent rights for target shareholders in respect of the arrangement.

At the interim court hearing, the court must be satisfied that the statutory pre-conditions to the availability of the arrangement procedure are satisfied. The fairness of the arrangement is not a consideration at the interim court hearing. For the interim hearing, the following materials are prepared and filed with the court in advance of the hearing:

- An application by the target to commence the court proceeding.
- A draft form of interim order.
- An affidavit sworn by an officer of the target that typically sets out: (i) a description of transaction, including the parties; (ii) the background to the transaction (e.g., any auction or bid-solicitation process); (iii) the recommendation and approval of the transaction by the target's special committee (if any) and board (including consideration of any fairness opinion); and (iv) the proposed mechanics for shareholder and court approval.
- The affidavit also attaches draft proxy materials.

Although the interim order motion is normally brought without notice to shareholders, it is open to shareholders to appear at the hearing and seek leave to make submissions. Following the granting of the interim order, proxy materials are finalized and provided to the target's shareholders, directors and auditors, in accordance with the interim order.

Shareholder Approval

An arrangement is typically approved by a special resolution of shareholders, meaning ⅔ of the votes cast (in person or by proxy) at the meeting.

In addition, if the arrangement constitutes a business combination for purposes of MI 61-101, then the arrangement will also be subject to MI 61-101's minority approval requirements, unless an exemption applies. In that regard, consideration needs to be given to the following:

- The arrangement will constitute a business combination if any director or officer of the target is entitled to receive, directly or indirectly, as a consequence of the arrangement: (i) consideration per equity security that is not identical in amount and form to the entitlement of the general body of holders in Canada of securities of the same class; or (ii) a collateral benefit.
- A collateral benefit is any benefit that a related party of the target (including directors or officers of the target and beneficial owners of securities carrying more than 10% of all voting rights) is entitled to receive as a consequence of the arrangement, including lump sum payments, subject to certain exceptions. The payment of transaction and retention bonuses and the acceleration of vesting of certain long-term incentive awards, for example, will factor into the collateral benefits analysis, unless they qualify under one of the prescribed exceptions.
- If the acquiror intends to offer an alternative form of consideration to certain related party shareholders (such as providing an equity rollover option to management when the consideration offered to public shareholders consists only of cash) or to provide retention inducements and/or equity incentive or other similar arrangements to the target's management team, then the arrangement will constitute a business combination and be subject to MI 61-101's minority approval requirements, subject to certain exemptions.

If the arrangement is subject to MI 61-101's minority approval requirements, the target would be required to obtain the approval of a majority of the votes cast (in person or by proxy) by shareholders, excluding the votes attached to securities beneficially owned, or over which control or direction is exercised, by related parties receiving alternative consideration or collateral benefits.

Final Fairness Hearing

The hearing for the final order approving the arrangement (known as the fairness hearing) is held shortly after the target shareholders meeting assuming that target shareholders have approved the arrangement. At the hearing, the target requests the court to grant a final order approving the arrangement. Target shareholders receive notice of this hearing through the proxy materials provided to them for the shareholders meeting, and have standing to make submissions as to whether the arrangement should be approved.

In determining whether to grant the final order, the court will consider the following (in addition to matters considered at the interim order hearing):

- Whether there has been compliance with the terms of the interim order and the governing corporate statute.

- That the necessary shareholder approvals have been obtained.
- That nothing is being done in the arrangement that is not authorized by the governing corporate statute.
- That the arrangement is being put forth in good faith and is fair and reasonable.

The most significant issue for the court's consideration is whether the arrangement is fair (both procedurally and substantively) and reasonable. Determining what is fair and reasonable involves two inquiries: first, whether the arrangement has a valid business purpose, and second, whether it resolves any objections of those whose rights are being arranged in a fair and balanced way. Whether these requirements are met is determined by taking into account a variety of factors including the result of shareholder voting. Other factors that may be relevant to this determination include:

- The process undertaken by the target leading up to the execution of the arrangement agreement.
- The considerations and recommendations of the target's board and, if applicable, any special committee.
- The conclusions of any fairness opinion obtained by the board or special committee and considered by it in making a recommendation concerning the arrangement to shareholders.
- Whether the transaction price represents a premium over the pre-announcement trading price of the target shares.
- Whether target shareholders have dissent rights in respect of the arrangement.
- Whether there are any dissenting shareholders or other stakeholders opposing the arrangement.

For the final hearing, the target will rely on the affidavit filed in support of the interim order describing the transaction and its background, as well as a supplementary affidavit confirming that there has been compliance with the interim order and the governing corporate statute in terms of calling and holding the shareholder meeting, and reporting on the results of the shareholder vote.

In addition to exercising dissent rights (if applicable), the target's shareholders may also oppose the application for the final order. The interim order sets out the notice that objecting shareholders must give in order to appear and be heard at the fairness hearing. If there are no dissenting shareholders, and no objecting shareholders, that information will also be put before the court in support of the fairness of the arrangement. Following the granting of the final order approving the arrangement (and assuming all conditions have been satisfied), the target can proceed to file the articles of arrangement, which is typically done as soon as possible after the final order is granted and after any required regulatory approvals are obtained.

Dissent rights

In an arrangement, unlike certain other corporate transactions, dissent rights are not statutorily mandated. Dissent rights may be granted to target shareholders as part of the court's interim order. The existence of

a dissent right and the level of dissent rights exercised by target shareholders giving rise to rights to terminate an arrangement transaction is a matter for negotiation between the acquiror and the target.

Additional procedural requirements

A target company will need to bear in mind the role of the Director under the applicable corporate statute when contemplating an arrangement. For example, the *CBCA Policy on Arrangements*, which applies only in the context of an arrangement carried out under the CBCA, sets out the views of the CBCA Director on a number of matters, including:

- The scope of permissible uses of an arrangement.
- Procedural guidelines, including required notices to the Director, interim and final orders, notices to affected constituencies and voting requirements, among other things.
- Substantive fairness, including fairness opinions and dissent rights.

The Director's position is that any proposed departure from the practices referred to in the Policy should be discussed in advance with the Director. The Director may appear before the court to oppose a proposed CBCA arrangement, either at the interim or final court hearing, if the Director believes that any departures from the Policy guidelines are not warranted.

In Ontario, there is also a requirement for prior notice to the OBCA Director. The OBCA Director is less involved in the substance, but must receive the required notice prior to the interim and final court hearing.

Availability of arrangement process to non-corporate entities

The arrangement is a creature of corporate law under which the jurisdiction of the court to approve arrangement transactions is limited to corporations governed by the applicable corporate statute. Nonetheless, because the arrangement is a well-understood transaction structure with benefits for targets, boards and securityholders, it may be used in respect of targets organized as trusts or limited partnerships. While those transactions often involve a step affecting a corporation, the court finds its broader supervisory and approval jurisdiction elsewhere (for example, for trusts under the *Trustee Act*) and, in those cases, the court process cannot be used to depart from the trust indenture or limited partnership agreement in respect of, for example, securityholder approval requirements. In that respect, a trust or limited partnership cannot be "arranged" in the sense that a corporation is arranged.[2]

Requirements for shareholder approval of acquiror

In situations where the acquiror is listed and offers its shares as full or partial consideration to target shareholders in an arrangement, stock exchange listing rules may require that the acquiror obtain approval from its own shareholders as a condition of completing the transaction if the number of shares to be issued exceeds a certain level. For an acquiror listed on the Toronto Stock Exchange, that threshold is more than

[2] See, for example, *Noranda Income Fund (Re)* a case in which an Ontario court permitted an acquisition of an income trust to proceed by way of a plan of arrangement.

25% of the acquiror's outstanding shares or if the transaction will materially affect control of the acquiror (for example, the creation of a new 20% shareholder of the acquiror). Formerly, a TSX listed issuer was not permitted to subsequently increase the number of shares issuable under the transaction without obtaining further shareholder approval, which was cumbersome and handcuffed acquirors in a contested situation. TSX guidance now enables an acquiror to top up the number of shares to be issued in an arrangement by up to 25% of the number approved by shareholders without obtaining further shareholder approval subject to certain disclosure requirements. This provides flexibility for an acquiror to quickly increase the consideration offered in a contested situation. Approval of an arrangement by the acquiring corporation's shareholders is not required as a matter of corporate law.[3]

[3] *Smoothwater Capital Corporation v Marquee Energy Ltd.*

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The target's board of directors

Overview of fiduciary duties

The target board's role is particularly prominent in change of control transactions, including friendly transactions carried out by way of an arrangement, because of the significance of such transactions for the corporation, the potential for management to be conflicted and the potential for misalignment between different stakeholder groups. While it is appropriate for management and the corporation's advisors to be very involved in the process, the process must be led by the board or a committee of the board, independently of management.

Issues that the board may be faced with include difficult business judgments as to whether to engage with an offeror, to support or reject an offer, to agree to measures to protect a supported deal, to seek out alternatives to an offer, and to implement and continue to deploy defensive measures against an offer.

Target directors' responsibilities in a change of control situation include:

- Determining whether to entertain an exclusive negotiation or run an auction.
- Considering the interests of all stakeholders.
- Providing adequate information to shareholders to allow them to make a fully informed decision about an acquisition proposal.
- Making a meaningful recommendation to shareholders to accept or reject an acquisition proposal or provide reasons why they are not doing so.
- Considering whether to solicit or receive potentially superior alternatives and whether the arrangement agreement or any proposed support agreements allow for that flexibility.

In addressing these issues, directors must discharge their duties of loyalty and care. Directors will have honoured their obligations and their decisions will not normally be second-guessed by courts if they follow the process and procedures described below.

The target board should consider, as a threshold matter, whether a proposal presents any conflicts for directors.

Conflicts may be addressed through the recusal of conflicted directors from decision-making concerning the proposal or by forming a special committee of independent directors to deal with the proposal. Whether

or not there are director conflicts, a special committee may be desirable as a matter of convenience to facilitate decision-making on a timely basis.[4]

The board should consider and assess potential management conflicts. For example, where management positions are threatened, management compensation is affected or management simply has a particular view of the merits of a change of control transaction, the board (or special committee), and not management, should have carriage of the process of considering and responding to the proposal.

Directors must make their decisions on the basis of all material information reasonably available in the circumstances. This means:

- Obtaining appropriate financial, legal and other advice, including possibly obtaining a fairness opinion from a financial expert regarding the fairness to shareholders (and, potentially, other securityholders) of any acquisition proposal.[5]
- Being aware of all alternatives reasonably available to the corporation in the circumstances.
- Understanding the background to all important decisions they are asked to make, including the business and financial implications of any actions or transactions.
- Questioning management and independent advisers about all aspects of the matter under consideration, including the information and assumptions on which advice was based.

Directors must have adequate time to deliberate in reaching decisions, which will often require more than a single meeting to consider an extraordinary transaction. Directors should be given advance notice of meetings that will address significant matters, draft copies of key documents or summaries of the material provisions of those documents, and an opportunity before a meeting to read that material so that they can come to the meeting prepared.

The decisions directors make must fall within the range of reasonable choices measured against the criterion of the best interests of the corporation. In the change of control context, the interests of affected stakeholders that must be considered in determining the best interests of the corporation may well not be aligned. For example, on the question of whether to support a premium offer that will put greater leverage on the corporation, supporting that offer might be in the interests of current shareholders, but contrary to the interests of creditors and employees. In such circumstances, while respecting legal rights and

[4] Canadian securities regulators are particularly attuned to the high standards to which special committees should conduct themselves regarding conflict transactions including related party transactions and insider related party transactions. Proper special committee process has been the subject of regulatory commentary (and criticism) in *Re Magna International, Re Sears Canada* and *Re ESW Capital, LLC.*

[5] Decisions of the Ontario Capital Market Tribunal and the Court of Appeal for the Yukon Territory have identified concerns that may arise when a fairness opinion is prepared by a financial adviser who is being paid a success fee, and concerns with the adequacy of disclosure regarding financial advice. Staff of Canadian securities regulators subsequently released guidance on material conflicted transactions addressing disclosure of compensation arrangements for financial advisors, and disclosure of the methodology used in rendering a fairness opinion. Directors should carefully consider compensation arrangements with financial advisors and the corporation's disclosure of financial advice, especially in connection with transactions that may be controversial. In some circumstances, directors should consider obtaining a second fairness opinion from an advisor not compensated on a success-fee basis. Also, the scope of the disclosure of the underlying analysis in fairness opinions is a matter that has been commented on in several cases and should be carefully considered in terms of whether a "long form" opinion that discusses the underlying financial analysis supporting the conclusion in detail is requested or whether a short form opinion more conclusory in nature that does not contain that level of detail will suffice. "Hybrid" fairness opinions have also been utilized which fall somewhere between the short and long form opinions in terms of degree of disclosure.

reasonable expectations, directors of a Canadian company must engage in a balancing exercise, with the weight to assign the conflicting stakeholder interests being a matter of business judgment for the directors.

A target's board should keep the following principles in mind when deciding whether to conduct a broad public auction:

- A public auction may often be advisable but is not required by law.
- Although price is persuasive, the highest bid is not automatically the best bid—the surrounding facts and circumstances must be taken into account.
- Market checks on the value of a target are valuable, but a market check may sometimes be achieved in ways other than via a public auction.

Process is critical to demonstrating that the board has appropriately fulfilled its duties. Records should be kept of directors' decisions, enabling them to demonstrate that they discharged their duties of loyalty and care. Minutes of directors' meetings should summarize the matters discussed and the advice obtained, demonstrating that the directors were focusing on the important issues, proceeding in a thoughtful manner and acting with a view to the best interest of the corporation. Records of directors' meetings should be maintained and should include copies of all relevant materials provided to board members to assist with their decision making.

A duty to maximize shareholder value?

Under corporate law in Canada, the corporation's interests are not determined by reference to the interests of shareholders alone. The mandate of the board in this context is not to maximize shareholder value. In light of the Supreme Court of Canada's decision in *BCE Inc. v. 1976 Debentureholders (BCE)*, the fiduciary duty analysis will be more complicated than simply maximizing shareholder value when the best interests of shareholders (to get the highest price possible for their shares) conflict with those of other stakeholders, such as bondholders. According to the SCC, acting with a view to the best interests of the corporation requires directors to consider the interests of all stakeholders; there is no overriding duty to maximize shareholder value.[6] Directors should tread carefully if they are considering sacrificing shareholder value for the interests of creditor or other stakeholder interests beyond the legal rights and reasonable expectations of these groups.

Deal protections

The parties to a friendly acquisition usually want to protect their deal from third-party interference and may also plan to compensate one side if the other side backs out. These protections are negotiated extensively as part of the arrangement agreement. Deal-protection measures are subject to the target board's fiduciary duties discussed above—that is, those duties cannot be constrained by contractual deal protections.

[6] For a comprehensive discussion of the fiduciary duties of directors in Canada, please refer to Torys' Business Law Guide *Directors' Duties in Canada*.

In an arrangement transaction, the acquiror will seek to protect the transaction against competition from potentially superior proposals that could be made to the target following announcement of the deal, but prior to the shareholder meeting. Conversely, the target directors, having regard to their duties, will be concerned about the potential for superior proposals. They will, on the one hand, not want to be unduly constrained in the event of a superior proposal, but on the other hand, will not want to deter the "bird in the hand" if the acquiror's willingness to make an attractive offer is conditional on reasonable protection from competition. This dynamic is typically addressed through some combination of "fiduciary out", "no-shop", "go-shop", "break fee" and "reverse break fee" clauses in the arrangement agreement.

No-shop and go-shop clauses

A "no-shop" clause prevents a target from soliciting competing offers. This clause is typically combined with a fiduciary-out clause, which entitles the target's board to consider unsolicited alternative transactions (sometimes referred to as "window shopping") to the extent necessary to fulfill its fiduciary duties. Before a target exercises its fiduciary out, it may give the incumbent bidder a chance to match the competing offer.

Some deals, particularly those involving financial buyers, may include a "go-shop" feature, which gives a target a specified period of time—usually 30 to 60 days after signing a transaction agreement—to actively seek out a higher-value transaction. A target may negotiate a go-shop if a full auction has not been conducted and the board believes, in exercising its fiduciary duties, that it needs to check the market to ensure that the price agreed to with the incumbent acquiror represents the maximum value obtainable in the circumstances. A no-shop period will begin once the go-shop period ends.

Break fees

If a target decides to abandon a transaction in favour of an alternative transaction, it will usually have to pay a break fee to the incumbent acquiror. The break fee, also known as a "termination fee," is typically in the range of 3-4% of the transaction's value. Break fees may justifiably be somewhat higher for smaller deals, where the absolute value of the break fee is still reasonable, or when an auction has been conducted and the target's value has therefore been tested by the market. In that case, the board may be more confident that vigorously protecting the deal is in the best interests of shareholders.

Setting break fees too high could violate the target board's fiduciary duties by unduly discouraging other potential acquirors from proposing a better transaction. Many institutional shareholders' voting guidelines require them to reject transactions involving excessive break fees.

Reverse break fees, being a fee payable by the acquiror to the target if the acquiror abandons the transaction, have also been seen in transactions when the target was not initially for sale or when it was necessary to compensate the target for additional regulatory or legal risks or for the risk that the acquiror will be unable to obtain financing to complete the transaction. In many cases, these reverse break fees are structured as the sole remedy for an acquiror's failure to close, making the deal effectively an option for the acquiror, and the fee the option price.

Asset lockups

Another form of deal protection involves the target granting a bidder certain rights over some of the target's assets (via a joint venture, licensing or option arrangement) that can be exercised if the target rejects the deal in favour of a superior proposal. Factors affecting the legitimacy of an asset lockup include the extent to which it impedes an active auction and the existence of an independent business justification for the lockup. An asset lockup has been upheld in Canada in a case in which the lockup was granted to a new bidder to encourage rather than inhibit an auction.

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Documentation

The key transactional documents in an arrangement transaction are:

- The arrangement agreement.
- The plan of arrangement.
- The management proxy circular prepared for the meeting of target shareholders to approve the transaction.
- The materials for the interim and final court hearings.

The arrangement agreement

Key provisions of the Arrangement Agreement typically include the following:

- Deal-protection measures such as:
  - break fee and expense reimbursement provisions specifying the circumstances under which the fees will be payable—for example, upon the target board's support of a superior competing transaction or upon a competing transaction being completed;[7] and
  - a no-shop clause (subject to a fiduciary out) enabling the board to consider unsolicited, potentially superior offers.
- Detailed representations and warranties regarding the target's business and disclosure.
- Certain representations regarding the acquiror's business and disclosure (if shares are offered as consideration or if there is a condition related to financing).
- Permission for continued access by the acquiror to confidential information about the target.
- A "material adverse effect" clause, which permits the acquiror to abandon the transaction upon certain negative changes in the target's business pending closing[8].

[7] The acquiror may also agree to pay a reverse break fee as a penalty if it fails to complete the transaction (often only for specified reasons, such as regulatory approval being denied or not being obtained in a timely matter or financing falling through, but also sometimes on a "no-fault" basis so the provision acts as a liquidated damages clause if the buyer fails to close for any reason).

[8] These type of MAE clauses, and interim operating covenants, have been the subject of significant litigation in both Canada and the United States particularly during the COVID 19 pandemic as some acquirors sought to terminate transactions. *Re Cineplex Inc. v Cineworld Group PLC* and *Fairstone Financial Holdings v Duo Bank of Canada* were significant cases that involved busted M&A deals.

- The target's agreement:
  - to carry on its business in the ordinary course until the transaction closes.
  - to assist with certain steps necessary in relation to the acquiror's financing arrangements.
  - not to take extraordinary actions or incur certain expenditures without consulting with or obtaining the consent of the acquiror.

The plan of arrangement

The plan of arrangement is the key corporate document to implement the arrangement under the target's governing corporate statute. The plan of arrangement is initially agreed to in the arrangement agreement and submitted to target shareholders in the proxy materials for the shareholders meeting, and later forms part of the final court order and the articles of arrangement by which the arrangement becomes effective. The plan of arrangement typically sets out:

- The detailed steps, sequencing and timing of each of the various transactions comprising the arrangement.
- Any elections required to be made by target shareholders, including with respect to receiving cash or share consideration.
- Adjustments to cash and share consideration to reflect agreed upon caps.
- Details of any amalgamations occurring as part of the arrangement.
- Treatment of fractional shares and rounding of cash consideration.
- Dissent rights granted to target shareholders.
- Mechanics for the delivery of consideration to target shareholders, including letters of transmittal, tax withholdings, interest and distributions and extinction of shareholder rights.

Proxy materials

The proxy materials provided to target shareholders in connection with an arrangement typically include:

- A notice of meeting.
- General proxy and voting information.
- A description of the details and consequences (including tax consequences) of the arrangement, which typically includes the various transaction steps.
- Background to the arrangement, which typically includes the reasons for the deal, the negotiations leading up to the signing of the arrangement agreement and details regarding special committee and board meetings and deliberations.

- A summary of any fairness opinions and/or formal valuations and the recommendation of the board (and any special committee) and reasons therefor.
- A summary of the key provisions of the arrangement agreement including conditions, covenants, deal protection provisions, termination rights and fees.
- Prospectus-level disclosure regarding the acquiror (including detailed historical and *pro forma* financial information) if securities of the acquiror are issued as full or partial consideration.
- Risk factors.
- Rights of dissenting shareholders.

The proxy materials also include as schedules the specific resolutions to be voted on by shareholders, the interim court order, the plan of arrangement, copies of any fairness opinions and valuations provided to the target board, details on dissent rights and the notice of application for the final court order. The arrangement agreement itself is included as a schedule (or incorporated by reference) and will be publicly filed by the target separately as a material contract.

If the transaction constitutes a “business combination” for purposes of MI 61-101 and minority approval requirements apply, the proxy materials are required to contain enhanced disclosure regarding prior offers, prior valuations and the identity and holdings of shareholders whose votes are to be excluded, among other things.

The proxy materials are not required to be formally pre-cleared with any Canadian securities regulator or stock exchange, but must be publicly filed concurrently with mailing to target shareholders. If MI 61–101 applies to the arrangement, then a real time review of the proxy circular could lead to regulatory comments that would need to be addressed before the target shareholders meeting.

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Other regulatory considerations

Antitrust/competition laws

Canada's *Competition Act* establishes procedural and substantive regimes for the review of transactions involving the acquisition of businesses operating in Canada. The policy statements and guidelines of the Canadian Competition Bureau, the federal agency responsible for enforcing Canadian competition laws, elaborate and expand upon the procedural and substantive requirements of the *Competition Act*.

Pre-merger notification

Procedurally, the *Competition Act* requires that pre-merger notification (PMN) be given to the Commissioner of Competition (Commissioner) of the proposed acquisition of voting shares of a public corporation that carries on (or controls a corporation that carries on) an operating business in Canada, if the parties and the transaction exceed the below thresholds:[9]

- **Size of the parties**. The parties to the transaction, together with their affiliates, have assets in Canada—or annual gross revenues from sales in, from or into Canada—that exceed C$400 million.
- **Size of the transaction**. The target corporation (or corporations controlled by it) has assets in Canada that exceed C$93 million, or annual gross revenues from sales in, from or into Canada that exceed C$93 million.[10]
- **Voting threshold**. As a result of the transaction, the purchaser will hold more than 20% (or more than 50%, if it already holds 20%) of the votes attached to all outstanding voting shares of the target corporation.

In addition to notifying the Commissioner of a proposed transaction, parties to notifiable transactions are required to supply the Commissioner with specified information and to await the expiration of a statutory (no close) waiting period before the transaction may be completed. The waiting period is 30 days unless prior to its expiry, the Commissioner issues a supplementary information request, which extends the waiting period until 30 days after the parties have provided the Commissioner with the required information.[11]

[9] In addition, regardless of whether a merger is notifiable, it can be reviewed by the Commissioner under the substantive merger provisions of the *Competition Act* both prior to closing (if the transaction comes to the Commissioner's attention) and for a period of up to one year following its substantial completion.

[10] The financial thresholds are reviewed annually and can be decreased, maintained or increased with reference to a GDP-indexed formula in the *Competition Act*.

[11] In addition, the Commissioner can apply to the Competition Tribunal for an order to delay the completion of a merger transaction by an additional 30 days (which can be extended to 60 days) beyond the statutory waiting period upon certifying to the Competition

Upon the completion of the review, the Commissioner typically issues a "no-action" letter to advise the parties that no application will be made to the Competition Tribunal for an order under the merger provisions of the *Competition Act*. If a no-action letter is issued, the Commissioner retains the right to challenge a merger transaction for up to one year after its completion.

Advance ruling certificates

As an alternative to a PMN filing, the parties to a notifiable transaction may apply to the Commissioner for an advance ruling certificate (ARC) that, if issued, both eliminates the PMN filing requirement and prevents the Commissioner from subsequently challenging the transaction. However, the issuance of an ARC is discretionary, and typically one will be issued only if the transaction does not raise any competition law issues.

Foreign investment review

The Canadian government encourages foreign investment if the investment will contribute to economic growth and employment opportunities in Canada. An investment by a non-Canadian that will result in the acquisition of control of a Canadian business is subject either to review and approval or to notification under the *Investment Canada Act*. Government approval is ordinarily required for direct foreign investments if the enterprise value of the Canadian business exceeds specified monetary thresholds. The current threshold for WTO investors is C$1.386 billion in target enterprise value.[12] Investors from countries with which Canada has free trade agreements are subject to a higher C$2.079 billion enterprise value threshold. Investors that are state owned enterprises (SOEs) are subject to a C$551 million in target book value of assets test. If the acquisition involves a Canadian "cultural" business, much lower thresholds apply. In the case of a direct acquisition, approval is required if the book value of assets of the Canadian business exceed C$5 million. In the case of an indirect (foreign-to-foreign) acquisition, approval is required if the Canadian business has book value of assets of C$50 million or more.

Where approval is required, the government will assess whether the investment is "likely to be of net benefit" to Canada. The "net benefit" assessment is based on the impact that the acquisition will have on the Canadian business. Investments are generally approved provided investors enter into binding undertakings relating to the maintenance and/or growth of the Canadian business. Typical undertakings relate to Canadian senior management, employment, production, R&D activity and capital expenditures. Investments by foreign SOEs are subject to additional investment policies designed to require the SOE to satisfy criteria relating to governance, transparency and commercial orientation. Most undertakings are usually three to five years in duration, but can be longer.

The review period usually lasts 75-90 days after a complete application is submitted.

Tribunal that an inquiry in respect of the merger is underway and that, in the absence of an order, a party to the merger would be likely to take action that would substantially impair the Competition Tribunal's ability to remedy the effect of the merger on competition.

[12] This threshold is adjusted annually based on growth in nominal GDP in accordance with a formula set out in the *Investment Canada Act*.

All other acquisition of control transactions, even if not subject to a net benefit approval requirement, must be notified to the government before or within 30 days after closing.

The government may review any notified investment and virtually any other foreign investment transaction (even if not involving an acquisition of control) if there are reasonable grounds to believe the transaction "could be injurious to national security." The Investment Canada Act does not define "national security". Generally, a risk assessment evaluation ought to include consideration of the following factors: (i) the country of origin of the investment; (ii) the extent of influence of a foreign government or foreign intelligence agency on the investor (i.e., in the case of an SOE or a private firm with close ties to its home government); (iii) the business activities of the Canadian business and its importance to Canada's competitive position and economic self-sufficiency (i.e., whether there could be a transfer of sensitive technology, a dependence on foreign suppliers or reduced availability of critical goods and services); and (iv) the proximity of the Canadian business' physical locations to infrastructure or operations important to Canada (i.e., whether the location could facilitate espionage or other foreign interference activities contrary to Canadian interests). Recent policy statements indicate that economic security will become a more important factor than it historically has been in assessing whether an investment could be injurious to Canada's overall national security.

Certain industries in Canada are also subject to quantitative limits on foreign ownership, and Canadian residency or citizenship is sometimes a prerequisite for serving as a director. The affected industries include broadcasting, insurance, airlines, banking and telecommunications. For example, the Broadcasting Act requires that Canada's broadcasting system be effectively owned and controlled by Canadians.

Tax planning

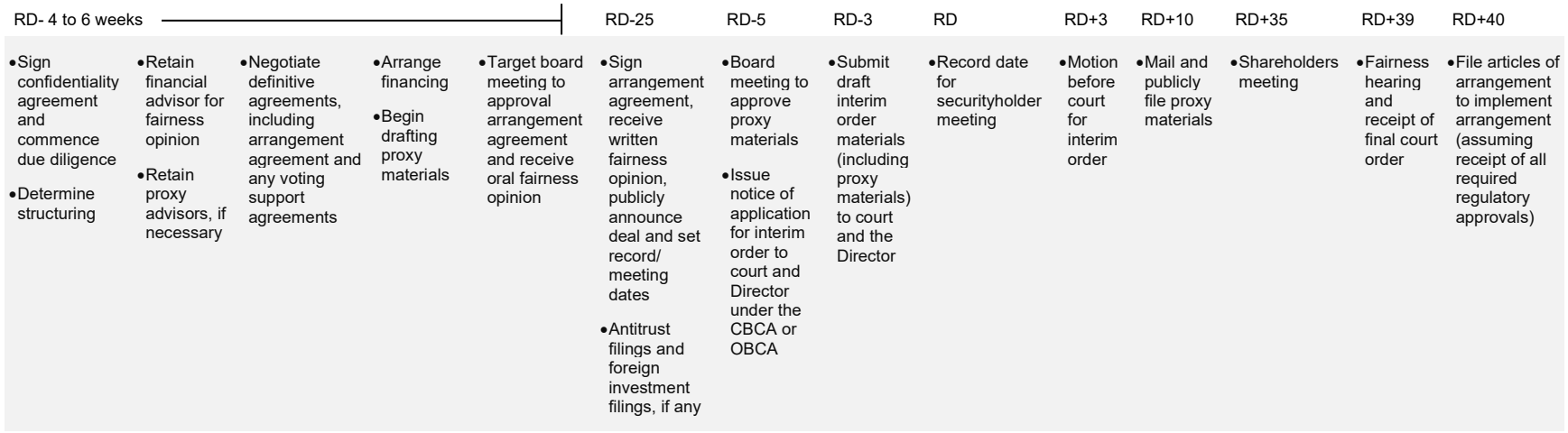
Although a detailed discussion of potential tax issues is beyond the scope of this guide, tax implications will be a key consideration in many arrangements and should be incorporated into the transaction planning at an early stage.

8

Appendix

Appendix A — Arrangement timeline

Timeline from commencement to implementation



RD = Record date for target shareholders meeting

About Torys LLP

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