Cross-Border M&A

Top 10 Considerations for U.S. Acquirers of Canadian Targets

Introduction

What are the key considerations for U.S. businesses and investors contemplating the acquisition of a Canadian target? What are the potential opportunities and pitfalls?

Our guide features top tips from specialists from Canadian law firm, McCarthy Tétrault LLP, to help U.S. investors and businesses understand core issues and considerations when contemplating the acquisition of a Canadian target.

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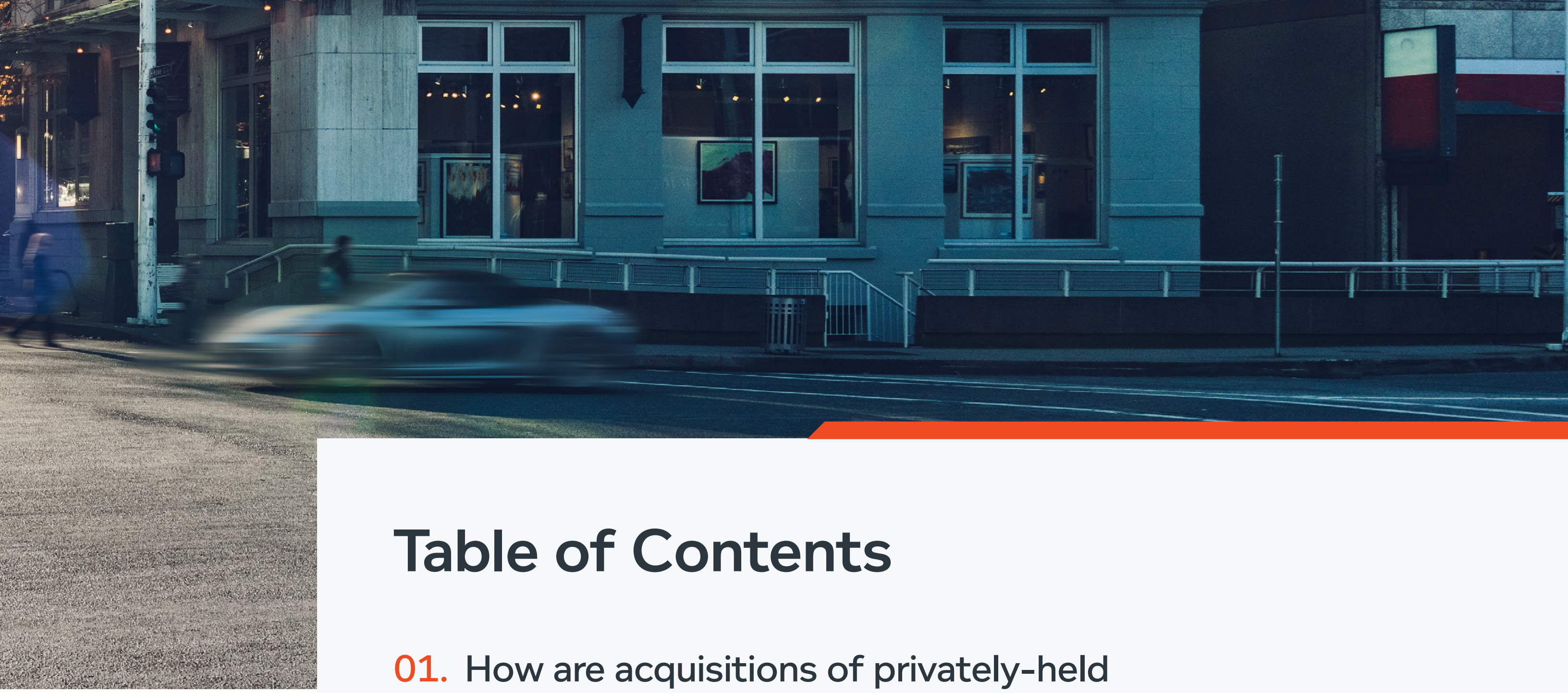

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This article is intended to provide a primer on certain issues regarding the acquisition of a Canadian business. The law in this area is complex. As such, this primer provides a summary rather than a detailed analysis of the relevant statutory provisions, case law and precedent transactions.

How are acquisitions of privately-held Canadian targets typically accomplished?

The acquisition of a privately-held company in Canada is most commonly effected through:

- a share purchase
- an asset purchase
- a hybrid share/asset transaction; or
- an amalgamation

The best structure for a given acquisition will depend on a number of factors, including tax considerations and the acquirer's willingness to acquire all of the assets and assume all of the liabilities of the target company.

SHARE PURCHASE

As in the U.S., a share purchase transaction involves the acquisition of the equity of the target company from selling shareholders. In Canada, a target's equity is referred to as "shares" or "share capital", rather than "stock", but the concepts are otherwise very similar.

Upon closing, the target company becomes part of the corporate structure of the buyer, who acquires all of the target's assets and liabilities.

The governing document is a share purchase agreement ("**SPA**"), which has many elements in common with a U.S. share purchase agreement. In the case of U.S.-based buyers who have a preferred form of SPA used for U.S. transactions, this form can often be adapted for use in Canada, though changes will be required to account for Canadian laws and regulations, such as different employment, environmental and tax laws. In the past, there were sometimes notable differences in what was considered "market" for certain deal terms in Canada and the U.S., such as liability caps and survival periods for representations and warranties; however, as the volume of cross-border transactions has increased in recent years, the gap between Canadian and U.S. deal terms has become negligible.

The articles of incorporation of Canadian private corporations often contain restrictions on share transfer, such as requirements for shareholder or director approval.

ASSET PURCHASE

Asset purchase transactions involve the acquisition of specific assets from a target company in accordance with the terms of a negotiated agreement. Upon closing, both parties maintain their separate corporate identities, meaning the seller maintains all residual assets and liabilities excluded from the transaction and the buyer only assumes the agreed-upon assets and liabilities, providing acquirers with the advantage of being able to select and pay for only those aspects of the target business that it values and wishes to acquire.

The governing document is an asset purchase agreement ("**APA**"), which is also similar to customary U.S. forms. The APA will typically schedule a list of the specific acquired assets and assumed liabilities. As in the U.S., asset purchase transactions tend to involve more extensive documentation to convey different types of assets, from intellectual property to land. They also typically trigger the need for more consents, particularly from contractual counterparties with respect to the assignment of agreements, which can lead to a longer and more costly transaction process. Special consideration must also be given to employment and pension matters and treatment of accounts receivable, among other issues, in an asset transaction.

Absent extraordinary circumstances, there is generally no concept of "successor liability" in Canada, so asset transactions can be an effective way to avoid acquiring unwanted liabilities from the seller.

A sale of all or substantially all of the assets of a corporation in Canada generally requires the approval of 66⅔% of its shareholders.

By allocating the purchase price among the acquired assets, asset purchase transactions will often provide purchasers with attractive opportunities to maximize income tax deductions for asset depreciation. Given that the interests of buyers and sellers in these allocations may diverge, the allocation of the purchase price to the acquired assets is typically addressed in the APA. Sellers, in contrast, will typically favor share transactions, which avoid the double taxation that arises from the taxation of both the target company, on the proceeds of the sale, and its shareholders, on any distribution of those proceeds. In a share transaction, only 50% of the capital gains realized from the sale of shares will generally be taxable, and depending on the circumstances, additional exemptions such as the lifetime capital gains exemption may apply to exempt the capital gains from tax entirely.

HYBRID TRANSACTIONS

"Hybrid" transactions involve a succession of asset and equity transactions designed to maximize the tax benefits of both the acquiring and target entities. Basic hybrid transactions begin with the buyer's acquisition of the target's shares, thus qualifying the selling shareholders for capital gains exemptions if the target is a small business. The buyer then proceeds with purchasing the target's assets, which may be priced in order to "step up" the acquirer's tax base and increase depreciation costs that may be used to lower future income taxes. The hybrid transaction is concluded by the redemption of the transferred shares by the buyer.

AMALGAMATIONS

Acquisitions can also be effected by way of amalgamating (merging) the target entity with a buyer entity, similar to a Delaware merger. However, this is not the preferred acquisition method in Canada.

While an amalgamation aims to achieve similar results to a merger—that is, combining two or more entities into one—the concepts of amalgamation in Canada and of mergers in the U.S. are fundamentally distinct. Amalgamation in Canada refers to a statutory process by which a new legal entity inherits the property, rights and liabilities of predecessor corporations.

Unlike Delaware mergers, amalgamations are essentially a means of continuing two or more predecessor entities as one newly created successor corporation. Since all predecessor corporations continue to exist following an amalgamation, the concept of a "surviving" corporation is not applicable under Canadian law. Amalgamations are commonly likened to the merging of streams to form a river: separate corporations are combined and collectively continue as a single entity.

In Canada, a corporation may be incorporated or continued under the federal corporate statute (the *Canada Business Corporations Act* ("**CBCA**")) or any of the thirteen provincial/territorial corporate statutes. In order to effect an amalgamation, all predecessor corporations must be governed by the corporate statute of the jurisdiction that issues the certificate of amalgamation. Accordingly, if two amalgamating corporations are formed under different jurisdictions, one of the corporations must be "continued" under the other corporation's jurisdiction prior to the amalgamation.

From a tax perspective, amalgamations are generally neutral. A taxation year of each predecessor corporation is deemed to have ended immediately before the amalgamation. The first taxation year of the amalgamated entity is deemed to begin at the time of the amalgamation.

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How should a U.S. acquirer structure a share acquisition of a privately-held target?

A common structure for U.S. buyers of Canadian shares is to incorporate a new Canadian acquisition company ("**AcquireCo**") to be the legal acquirer of the shares and then, immediately post-closing, amalgamate AcquireCo with the Canadian target. This structure is frequently used as it allows for:

1. push-down of any acquisition financing into the Canadian operating business (which, in turn, allows the Canadian business to deduct the interest expense against income);
2. tax-efficient repatriation of funds from Canada back into the U.S., up to the original equity amount of the purchase price, without triggering Canadian withholding tax; and
3. the opportunity to utilize the Canadian tax bump (as described below)

Following the purchase, the buyer usually amalgamates the AcquireCo with the target. By capitalizing the AcquireCo with the funds necessary to pay the purchase price for the shares of the target, the buyer will, following the amalgamation, have effectively invested capital in the company equivalent to the purchase price of the business (called the "**paid-up capital**" or "**PUC**"). This allows the buyer to withdraw an equivalent amount of capital from the company at a later stage on a tax-efficient basis, since PUC can be distributed back to the U.S. parent as a "return of capital" (rather than, for example, a dividend) free from withholding tax. If the buyer had simply paid the purchase price to the shareholders of the seller directly (that is, rather than conducting the purchase through an AcquireCo and amalgamating it with the target), the buyer could only withdraw the amount of capital originally invested in the acquired company (which may be far less than the amount of the purchase price).

Canadian corporate statutes do not provide for entities similar to Delaware limited liability companies ("**LLCs**") to use as acquisition vehicles. Some provinces have "unlimited liability companies" ("**ULCs**"), which afford

the opportunity for flow-through tax treatment, but these must be used with caution given the anti-hybrid rules in the Canada-U.S. tax treaty.

Transactions in Canada involving the sale of "taxable Canadian property" (generally speaking, the Canadian equivalent to U.S. FIRPTA property) can require a clearance from Canada's federal tax authority, the Canada Revenue Agency ("**CRA**") or a partial holdback of the purchase price.

The Canadian thin capitalization rules require that debt owing to related non-resident parties (such as U.S. parent companies) not exceed 1.5 times equity (see Section 6 of this guide for additional details).

In asset purchase transactions, it is also important to consider sales taxes (and whether exemptions from such taxes are available) and land transfer taxes.

CANADIAN TARGETS WITH U.S. SUBSIDIARIES

From a tax perspective, it is generally inefficient to interpose Canadian entities between foreign parent companies and subsidiaries. "Canadian sandwich structures" can give rise to costly inefficiencies related to withholding tax and foreign affiliate dumping rules.

"Bump" transactions can be used to extract a target's foreign subsidiaries from Canada to the U.S. on a tax-free basis. A "bump" refers to the cost base step-up provided by section 88(1)(d) of the Canadian *Income Tax Act* when a Canadian subsidiary ("**Canadian SubCo**") is wound up or amalgamated with its Canadian parent ("**CanCo**").

To effect a basic bump transaction, a U.S. investor typically incorporates a Canadian AcquireCo (CanCo) to purchase all of the outstanding shares of the M&A target (Canadian SubCo), whose assets consist of the shares it owns in its foreign subsidiaries ("**Foreign SubCos**"), and subsequently CanCo and Canadian SubCo are amalgamated or Canadian SubCo is wound up into CanCo. The Canadian tax bump rules may allow the amalgamated corporation (or CanCo, where Canadian SubCo is wound up) to step up or increase the cost basis of the shares of the Foreign SubCos to their fair market value calculated at the time of the acquisition of control of Canadian SubCo. Where the Canadian tax bump is available, CanCo may distribute the shares of the Foreign SubCos to the U.S. investor free of Canadian withholding tax by way of return of paid-up capital, extracting the Foreign SubCos from the "sandwiched" position as subsidiaries of a Canadian entity.

Bump transactions are subject to complex restrictions and may not be available in all circumstances. Most notably, the bump denial rule, subject to certain exemptions, disallows transactions in which selling shareholders retain a direct or indirect interest in the amalgamated corporation.

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What special considerations arise in acquisitions of interests in public companies in Canada?

ESTABLISHING A TOE-HOLD / EARLY WARNING

In Canada, it is permissible for a third party considering a take-over bid to purchase up to 9.99% of the target company's outstanding securities in the market without any requirement to identify itself and its holdings through disclosure. This is in contrast to similar requirements in the United States which arise at the 5% level. Once the third party purchases securities taking it to or over the 10% threshold, it must give notice to the market by issuing a press release no later than the opening of trading on the next business day and filing, within two business days, an "early warning" report in the prescribed form (which must include disclosure of the purpose for the transaction, including plans or future intentions which the purchaser may have with respect to the target company). Note that the initial reporting threshold drops from 10% to 5% where there is already a bid in the market.

The third party could potentially continue purchasing securities up to the 20% level before being required to make a formal take-over bid, although it will be required to report any further acquisitions of 2% or more in a similar manner and, in practice, the stock price typically jumps when the press release is issued at 10%, making further purchases less attractive.

A prospective bidder contemplating the acquisition of a toe-hold will need to consider a range of potential legal and tactical implications, details of which are beyond the scope of this primer. Any accumulation of target company securities by a bidder in advance of a formal take-over bid should be done carefully to avoid the bidder inadvertently being caught by Canadian "pre-bid integration" rules. These rules provide that if a formal bid is launched and, during the 90 days preceding the bid the bidder acquired target securities in any transaction not generally available to all shareholders,

then the consideration offered in the formal take-over bid must be at least equal to the highest consideration that was paid on a per share basis under any of the prior transactions.

A potential purchaser that acquires over 10% of the target company in preparation for a formal take-over bid becomes an "insider" when the 10% threshold is exceeded and subject to insider reporting obligations. Insiders that make take-over bids or propose "related party transactions" can be subject to heightened disclosure and shareholder approval requirements. See the discussion below under "Related Party Transactions".

ACQUISITION STRUCTURES

There are two commonly used methods to acquire a public company in Canada: take-over bids and business combinations.

TAKE-OVER BIDS

The first and most straightforward approach is a take-over bid, whereby the bidder makes its offer directly to the target company shareholders. A take-over bid is defined generally as an offer made to a person in Canada to acquire outstanding voting or equity securities of a class of securities, which, if accepted, would result in the bidder (together with persons acting in concert with the bidder) owning 20% or more of such class.

Most commonly, the bidder will make an offer to all of the shareholders of the target company to buy their securities for cash, non-cash consideration (typically, securities of the bidder), or a combination of cash and non-cash consideration. All holders of the same class of securities must be offered identical consideration. This means that it is not permissible to have collateral agreements with, for example, a controlling shareholder or a shareholder who is a senior officer that would result in additional consideration flowing to that shareholder (subject to certain exceptions covering, for example, employment contracts or severance arrangements). In addition, any purchases made by the bidder of securities that are of the same class as the securities that are subject to the bid and that were effected during the 90 days prior to the bid will be "integrated" into the bid. This means that the bidder will be required to offer to acquire the same percentage of securities and offer to pay the same amount and form of consideration as was offered in any pre-bid acquisitions, excluding normal course purchases on a stock exchange.

The offer must remain open for shareholders to accept for at least 105 days (referred to as the "bid period"), subject to a target board's decision to reduce the bid period. A take-over bid must be subject to a non-waivable condition that more than 50% of all outstanding target securities, excluding securities owned or held by the bidder and its joint actors (the "minimum tender requirement"), be tendered and not withdrawn before the bidder can take up any securities under the take-over bid. The take-over bid must also be extended by the bidder for at least an additional 10 days after the bidder achieves the minimum tender condition and all other terms and conditions of the bid have been complied with or waived.

Certain take-over bids are exempt from compliance with the foregoing requirements, including:

- **normal course purchases on an exchange, at the prevailing market price for the securities, not exceeding 5% of the outstanding securities of the class (whether acquired in reliance on this exemption or otherwise) in a 12-month period (referred to as the de minimis exemption);**
- **transactions involving the acquisition of securities from not more than five shareholders of the target company, provided that the price paid does not exceed 115% of the prevailing market price (referred to as the private agreement exemption); and**
- **foreign take-over offers where, among other things, the number of securities held beneficially by Canadian shareholders is reasonably believed to be less than 10% of the total outstanding securities, and Canadian shareholders are entitled to participate on terms at least as favourable as other shareholders.**

Second Step Takeout Transactions

If the bidder succeeds in acquiring at least 90% of the target company securities within 120 days of the commencement of the bid (other than securities owned by the bidder at the commencement of the bid) then the corporate statute governing the target company typically provides that the bidder can effect a "compulsory acquisition" to acquire the securities held by the remaining target shareholders through a relatively simple statutory process. This process can take up to 30 days or so, although the timing varies depending on the jurisdiction of incorporation of the target company.

Depending on the target company's jurisdiction of incorporation, the bidder's exercise of its compulsory acquisition right may trigger "dissent rights" for the non-tendering shareholders, which would entitle them to have the "fair value" of their securities determined by a court.

Alternatively, if the bidder acquires at least two-thirds of the outstanding securities, but less than 90%, the bidder may call a special meeting of the shareholders of the target company (including the bidder) for the purposes of voting on an amalgamation with an affiliate of the bidder, the result of which will be that the remaining "minority" shareholders are squeezed out for the same consideration that was offered in the take-over bid. Subject to certain conditions, the votes attached to securities acquired under the bid may be included as votes in favour of the amalgamation for purposes of determining whether the required minority approval has been obtained. This second step take-out transaction (which is often referred to as a "squeeze-out merger") takes longer than the 90% compulsory acquisition under the corporate statute because of the need to call a meeting of the shareholders of the target company.

BUSINESS COMBINATIONS

Negotiated acquisitions of Canadian public companies are most frequently effected not by way of a take-over bid, but rather through a "business combination", which is a statutory procedure (such as an amalgamation, consolidation or plan of arrangement) under the target company's corporate statute.

By far the most common form of business combination is the "plan of arrangement". The corporate statutes in Canada generally provide that companies can be merged and their outstanding securities can be exchanged, amended or reorganized through a court-supervised process known as a plan of arrangement. The target company will apply for an initial court order directing the target company to seek the approval of its shareholders and fixing certain procedural requirements for obtaining such approval. A second court appearance will be scheduled for shortly after the shareholders have voted at which the court will consider the substantive fairness of the transaction and any interested party may appear and object to the completion of the transaction. If the price is right, the shareholders will generally vote to approve the transaction (again, typically by at least two-thirds of the votes cast at the meeting) and, in the absence of meritorious objections from other interested parties, the court will give its approval and the relevant transactions will become effective. Often, the sole purpose for the plan of arrangement is to have the shareholders of the target company exchange their securities for either cash or some other form of consideration.

The plan of arrangement has two significant advantages in the right circumstances.

1. One is that it allows for multiple transactions to happen all at once or in a specified sequence following the approval of the shareholders and the order of the court. This can sometimes be useful, for example, where there are multiple companies involved in the transaction, where several classes of equity and debt securities are outstanding, or where the sequencing of particular steps in the transaction is important to achieve an advantageous tax result.
2. The other advantage to a plan of arrangement is that it will generally permit securities of the bidder to be issued to U.S. holders of the target company without requiring such securities to be registered in the U.S.

Although the plan of arrangement is a creature of Canadian corporate law statutes, there have been several recent examples of Canadian courts approving plans of arrangement involving non-corporate entities, for example, real estate investment trusts.

RELATED PARTY TRANSACTIONS

Certain rules (the "related party rules") impose additional requirements on some acquisitions of public companies where the acquirer is a significant shareholder or other insider. A common example occurs where a significant (greater than 10%) shareholder of a public company offers to purchase the securities held by the other shareholders (the so-called "minority" shareholders). To protect minority shareholders in these circumstances, the related party rules require that an independent valuation of the target company securities be prepared under the supervision of a committee of independent directors. This valuation is then provided to the minority shareholders with the take-over bid circular or management information circular for the transaction so that they have an independent assessment of the value of the target company.

In certain cases, where a shareholder vote is required for a significant transaction between a public company and an insider, the related party rules require that, in addition to any vote otherwise required by corporate law (usually two-thirds of the votes cast at a meeting), it will also be necessary for the transaction to be approved by a majority of the minority shareholders.

There are a number of exemptions available from these rules, generally premised on some aspect of the proposed transaction providing assurance that the insider has been treated as an arm's length party for the purposes of the transaction.

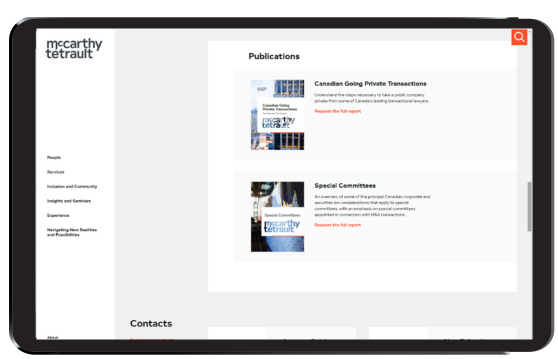
POISON PILLS

Until recently, a shareholder rights plan in Canada could be used to slow-down a hostile bidder so that the target board had more time to canvass alternatives that might maximize shareholder value. Unlike in the United States, they could not be used to delay a hostile bid indefinitely (the "just say no" defense). With the new Canadian rule that a hostile bid has to be open for at least 105 days (rather than merely 35 days under the old regime), the historical rationale for a shareholder rights plan in Canada no longer exists.

Shareholder rights plans remain a relevant tool for purposes of deterring creeping take-over bids. As mentioned above, any purchase in the market that takes a shareholder above 20% ownership of the target company continues to require the bidder to make a formal take-over bid to all the target's shareholders on identical terms, subject to the exemptions discussed above. Many Canadian public companies have rights plans that prohibit the use of these two exemptions to acquire control of the company.

For a detailed overview of Canadian going-private transactions, please visit:

mccarthy.ca/sites/default/files/2020-07/McT_Canadian_Going_Private_Whitepaper.pdf



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How will the board of directors of a target company assess a potential transaction?

The conduct of the target's board of directors will be governed by the provincial or federal corporate statute under which the corporation is incorporated. Under the *Canada Business Corporations Act*, the board of a public company considering a change of control transaction must:

- act honestly and in good faith with a view to the best interest of the corporation; and
- exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Acting in the best interests of the corporation requires directors to consider all stakeholders affected by the transaction, not just shareholders. This is in contrast to the Revlon Rule, a concept of shareholder primacy emerging from Delaware case law that reduces a target board's obligations in a change of control transaction to maximizing shareholder value.

In Canada, the duties of a target company's directors may generally be considered to be satisfied as long as the directors follow appropriate processes (including processes to appropriately inform themselves and to avoid conflicts of interest, such as through the formation of a special committee), respect the legal rights and any other reasonable expectations of securityholders and creditors and consider the interests of all stakeholders involved in a transaction.

For a more detailed discussion of board duties in the context of a Canadian public company subject to an acquisition proposal, please visit:

mccarthy.ca/sites/default/files/2020-07/McT_Special_Committees_Whitepaper.pdf

05

What key tax issues should a U.S. acquirer be aware of when purchasing a Canadian company?

Foreign investors' choice of acquisition vehicle and of funding to purchase a Canadian target is greatly informed by tax considerations such as refundable tax credits, small business deductions, tax attributes, pool balances and deemed year-ends.

The following highlights some of the principal tax matters that should be considered when effecting a private M&A transaction in Canada.

NO TAX CONSOLIDATION

Canadian tax law does not permit corporate group loss transfers or consolidated reporting. As such, losses incurred by an entity within a corporate structure cannot be used by its parent company or related subsidiaries to offset capital gains. This being said, profitable entities may access the unused tax losses accumulated by another within the same corporate group on liquidation, amalgamation or by effecting typical tax loss planning consolidation transactions.

THIN CAPITALIZATION RULES FOR DEBT

The debt/equity structure of a Canadian subsidiary is subject to thin capitalization rules, which operate to deny the deduction of interest payable to specified non-residents by the subsidiary to the extent that it is "thinly capitalized." A subsidiary is considered to be thinly capitalized where the amount of debt owed to the non-resident shareholder is more than 1.5 times the aggregate of the retained earnings of the corporation, the corporation's contributed surplus that was contributed by the non-resident shareholder and the paid-up capital of the shares owned by the non-resident shareholder. Interest that is not deductible because of the thin-capitalization rules is deemed to have been paid as a dividend and is subject to withholding tax as such.

WITHHOLDING TAX

Canada levies a 25% withholding tax on the gross amount of certain types of Canadian source income of non-residents. While dividends are subject to withholding tax, the return of PUC from a subsidiary to a U.S.–resident parent (the capital received by a company in exchange for its shares on their first issuance) is not.

As discussed above, effecting an M&A transaction using a Canadian holding company may enable investors to make distributions free of Canadian withholding tax.

Can we use representation and warranty insurance in a Canadian deal?

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While Canada initially lagged behind the U.S. in the adoption of the use of representation and warranty insurance ("**RWI**"), its use in Canada is now prevalent for private M&A transactions, particularly in mid-market and private equity transactions. As in the U.S., RWI—insurance that covers breaches of representations and warranties in a purchase agreement—can offer an attractive value proposition for both buyers and sellers. For sellers, RWI provides a means for them to limit their indemnification risk and reduce the amount of the purchase price that may be subject to escrow conditions prior to being paid out to them, offering a faster exit from the business with lower and more certain exposure to potential claims. For acquirers, RWI provides protection against the potential need to pursue sellers following the closing of the transaction to claw back portions of the purchase price to cover indemnification claims, providing assurances that in turn enable acquirers to offer sellers more favourable transaction terms. The use of RWI may also help avoid protracted and complex negotiation of representations and warranties between buyers and sellers, enabling transactions to be closed more swiftly, cost-effectively and amicably. This can be particularly desirable in private equity transactions, in which sellers may have continued involvement in the target company post-closing and the parties may wish to avoid adversarial negotiations that could strain the parties' future working relationships. In cross-border transactions, the use of RWI has provided a means to bridge some of the differences in market terms in the U.S. and Canada, resulting in the increasing convergence of terms noted above.

As the use of RWI in Canada has increased and competitive insurance providers have entered the market, the cost of placing an RWI policy in Canada has decreased dramatically in recent years and the availability of more flexible and customized solutions for risk allocation has increased. While terms vary and continue to evolve, a 1% retention amount (often split equally by the buyer and seller, with 50% of the retention amount held in an indemnity escrow) is quite standard, while RWI policy premiums tend to be very similar to premiums paid in the U.S. Coverage is typically based on a percentage of deal value—frequently 10% of the purchase price. The policy may be purchased by either the buyer or the seller, or the cost may be shared between the parties.

As in the U.S., RWI policies will typically not cover known or particularly high-risk issues, so notwithstanding the use of RWI, it may still be necessary for acquirers to insist on inclusion of special indemnities and escrows in the transaction agreement. Depending on the nature of the exclusions, the industry of the target, and other risk factors, the benefit of using RWI may vary from transaction to transaction, and the specific policy terms should always be carefully reviewed and considered in the context of the specific transaction. Despite its attractiveness, the use of RWI generally does not provide acquirers with protections that are precisely equivalent to traditional M&A deal terms; for example, traditionally, fundamental representations and warranties (such as representations and warranties concerning the ownership of the acquired shares and right to transfer them) are subject to a liability cap equal to the purchase price, whereas with RWI, such representations and warranties will often subject to the same cap applicable to non-fundamental representations and warranties. Likewise, if dealt with solely through the RWI policy, indemnification for pre-closing tax liabilities, which may be uncapped or subject to a cap equal to the purchase price in non-RWI transactions, will typically be subject to the cap of the RWI coverage amount in a transaction featuring RWI. Acquirers may wish to consider obtaining further insurance coverage or negotiating additional contractual protections to address these potential shortfalls.

07

What does a U.S. acquirer need to know about Canadian employment law?

In Canada, jurisdiction over employment is divided between the provincial legislatures and the federal Parliament ("**Parliament**"). The basic rule is that the provinces have jurisdiction over employment within their borders, including concepts such as minimum wage, hours of work, and overtime pay. Parliament has jurisdiction over employment by way of exception, when that employment is related to a subject over which Parliament has constitutional authority (such as telecommunications and transportation). Unlike in the U.S., there is no National Labor Relations Board governing the entire country's unionized workforce.

TERMINATION

In the U.S., an employer may be able to terminate an employee's employment "at will." In Canada, unless there is a legal justification for termination of employment (such as the narrow concept of "just cause", or if the employee has a written employment agreement specifying a termination package), the employer is obligated to provide reasonable notice of termination or compensation in lieu of notice (a "without cause" termination). Practically speaking, it can be difficult to prove the legal justification to terminate employment, resulting, more often than not, in the Canadian employer providing a termination package.

In certain Canadian jurisdictions, notably the federal jurisdiction, Québec and Nova Scotia, certain employees who have reached particular thresholds of years of service may not be discharged without just cause. In such jurisdictions, providing notice or pay in lieu of notice may not be sufficient to end the employment relationship, and a qualifying employee may be able to claim a right to be reinstated in his or her employment depending on the circumstances of termination.

In addition to termination without cause, an employee may consider his/her employment terminated if an employer changes a fundamental term of the employment relationship without the employee's consent. This concept is called "constructive dismissal". For example, constructive dismissal may occur when an employer decreases salary, reduces hours and/or relocates an employee without consent or notice.

Employment standards statutes in Canada also have provisions that apply where an employer terminates the employment of large numbers of employees in a short period of time. These provisions include, at the very least, advance written notice to the Director of Employment Standards or an equivalent governmental authority. Failure to provide such notice may result in increased liability to the employer. The numerical and timing triggers for such "group" termination provisions and how they might apply to a group of related entities may vary according to jurisdiction.

SUCCESSORSHIP

Most minimum standards legislation across Canadian jurisdictions includes successor employer provisions. These provisions stipulate that an entity that acquires a Canadian business will assume at least the basic statutory obligations of the former employer in relation to the business' employees. The employees have access to government agencies to enforce the "new" employer's assumed obligations (which range from accumulated severance obligations to accrued and unpaid vacation entitlement).

Less well-known is the concept of non-union successorship. Employment standards legislation generally deems employment to be continuous when a business is sold and the employees continue in employment with the buyer. In such cases, the seller will not have termination obligations. Rather the buyer takes on the employees with accrued seniority and other rights. Each jurisdiction is different, so the applicable statute must be considered.

HUMAN RIGHTS

Two principal regimes exist in Canada with respect to human rights:

The Canadian Charter of Rights and Freedoms (the "Charter"): This is a "bill of rights" that forms part of Canada's constitution. It applies to all government entities and the activities of these entities at the federal, provincial, territorial, and municipal levels. Note, however, that it does not affect the actions of private-sector employers.

Federal, Provincial and Territorial Human Rights Legislation: Specific statutes have been adopted in each jurisdiction and affect a variety of activities in those jurisdictions, including employment. Government, public-sector and private-sector employers and employees are all affected by these statutes.

Each jurisdiction has its own human rights legislation, usually called a code or an act (or in Québec, a charter). This legislation covers employment within that jurisdiction. Federally regulated entities such as federal Crown corporations (for example, Canada Post Corporation or the Bank of Canada) are required to adhere to the *Canadian Human Rights Act*, as are private companies such as railroads, airlines, banks, telephone companies and radio or TV stations. Provincially or territorially regulated entities look to the statute in their jurisdiction for human rights rules.

Like in the U.S., an employer is prohibited from engaging in discriminatory practices, unless it meets a stringent bona fide occupational requirement (BFOR). However, in Canada, the level of accommodation is to the «point of undue hardship.» This standard will vary depending upon the individual situation and the scope of the employer's operations. Unlike in the U.S., where accommodation may have a low financial threshold before discharging this legal obligation, in Canada there are no prescribed compliance requirements. Each case is examined on its own merits.

What should an acquirer focus on when evaluating a Canadian target's pension and benefit plans?

Benefits and pension plans in Canada consist of a combination of mandatory federal and provincial schemes and employer-sponsored programs. As the plans are not subject to uniform federal legislation in the nature of the *U.S. Employee Retirement Income Security Act* (ERISA), U.S. investors must carefully evaluate potential targets' pension and benefits liabilities in light of the applicable provincial standards and federal tax legislation. Importantly, pension plan underfunding/withdrawal liability are standard breaches excluded under Canadian representation and warrant insurance policies.

08

CANADA PENSION PLAN AND THE QUÉBEC PENSION PLAN

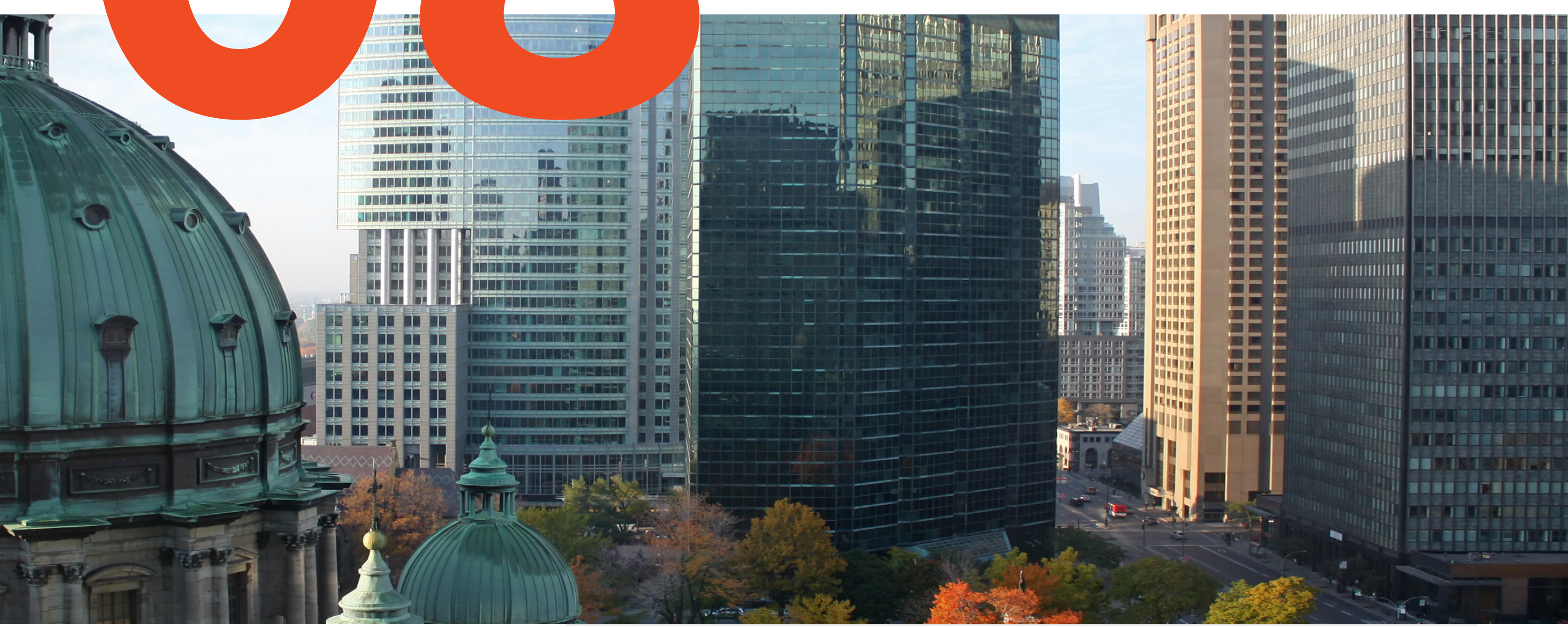
The Canada Pension Plan is a federally created plan that provides pensions for employees, as well as survivors' benefits for widows and widowers and for any dependent children of a deceased employee.

All employees and employers, other than those in the Province of Québec, must contribute to the Canada Pension Plan. The employer's contribution is deductible for income tax purposes. Québec has a similar pension plan that requires contributions by employers and employees within Québec.

EMPLOYMENT INSURANCE PLAN

In addition to the Canada Pension Plan, both employees and employers must contribute to the federal Employment Insurance Plan, which provides benefits to insured employees when they cease to be employed, when they take a maternity or parental leave and in certain other circumstances. The employer's contribution is deductible for income tax purposes. Québec also has its own Parental Insurance Plan.

Note that for both the Canada Pension Plan and Employment Insurance Plan, mandatory contributions do not apply to independent contractors.



HEALTH INSURANCE AND TAXES

All provinces provide comprehensive schemes for health insurance. These plans provide for medically necessary treatment, including the cost of physicians and hospital stays. They do not replace private disability or life insurance coverage.

Funding of public health insurance varies from one provincial plan to another. In some provinces, employers are required to pay premiums or health insurance taxes and in others, individuals pay premiums. In still others, the entire cost of health insurance is paid out of general tax revenues. Employers commonly also provide supplemental health insurance benefits through private insurance plans to cover health benefits not covered by the public health insurance plan.

WORKERS' COMPENSATION

Employers may be required to provide sick or injured worker benefits, in the form of workers' compensation, a liability and disability insurance system that protects employers and employees in Canada from the impact of work-related injuries. This benefit compensates injured workers for lost income, health care and other costs related to their injury. Workers' compensation also protects employers from being sued by their workers if they are injured on the job.

09

What privacy law considerations are relevant to the acquisition of a Canadian company?

Canadian businesses are subject to legislation that governs how they process personal information ("**PI**"), what they must do if they experience a data breach, and how they send commercial electronic messages (e.g., emails and text messages). While every organization that processes PI in Canada or engages in electronic marketing needs a robust compliance program, there are three key risks for acquirers: (**1**) they cannot use the PI in the possession of the target for their intended purpose; (**2**) the target has had a significant unknown or undisclosed data breach; and (**3**) the target is vulnerable to significant fines for a violation of Canada's anti-spam legislation.

UNUSABLE PERSONAL INFORMATION

In order to process PI in Canada, organizations generally need the consent of the data subject or an exemption to the consent requirement. Without either consent or an exemption, an organization cannot use PI, even if the data subject willingly provided it. While implicit consent is often sufficient for non-sensitive PI, such as mailing or email address, explicit consent may be required for more sensitive PI, such as medical or financial information or large volumes of information that is not sensitive in isolation.

Often, organizations have insufficient consent to process PI as they have been doing or to allow the acquirer to process the PI as they intend.

Two examples include:

1. **Consent to use data brokers:** Data brokers collect PI about individuals from public and non-public sources and resell it to other companies. Data brokers are widely used by U.S. companies for a multitude of purposes, including to correct errors in or verify PI they already possess, identify individuals who may have an interest in certain goods for advertising and marketing purposes, or even research specific individuals for various reasons. While the use of data brokers is not totally prohibited in Canada, it likely requires the express consent of the individuals whose PI is being shared, due to

the large volume of data being collected and because it is not something customers would expect. Express consent requires a positive action by the individual, such as clicking on an "I consent" button. Merely explaining the practice in a privacy policy is likely insufficient to comply with Canadian privacy legislation, making the use of data brokers impractical for many companies.

2. **Consent to transfer PI as part of a transaction:** Many transactions require the transfer of PI from the target to the acquirer, such as in an asset purchase transaction. However, even a share purchase may be considered a "disclosure" of PI to the buyer. The transfer requires consent of the data subjects. If there is no consent, organizations can rely on an exemption to the consent requirement contained in the legislation. However, the exception is a "next-best" to consent, as it is limited and onerous and requires the notification of the affected data subjects.

DATA BREACHES

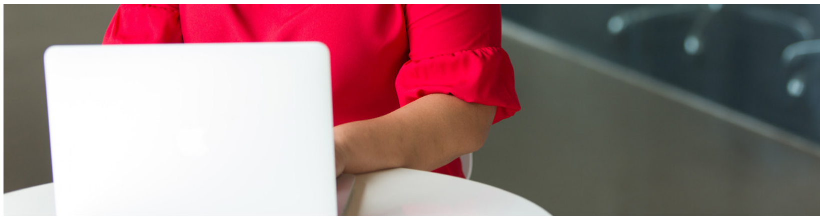
Acquiring a Canadian company that has experienced a data breach presents significant risks for a potential purchaser. Such companies may become subject to investigations, fines and orders by provincial or federal privacy commissioners, or, even worse, multi-million-dollar class action proceedings brought by data subjects affected by the data breach. Often, data breaches are not discovered for months or years after they occur, particularly in organizations with weak security and monitoring.

Notably, Canada has mandatory breach reporting in some cases, which requires an affected company to notify the affected data subjects and report to the applicable privacy commissioner. Organizations are also required to maintain records of the breach.

U.S. companies considering the acquisition of a Canadian company can mitigate these risks by ensuring that the target has not experienced a significant data breach—and if they have, ensuring they have complied with applicable legislative requirements regarding recording and reporting—and if they have not, ensuring they have adequate internal processes and security measures to guard against and respond to data breaches in the future.

ANTI-SPAM VIOLATIONS

Canada's anti-spam legislation ("**CASL**") prohibits Canadian companies from sending unsolicited electronic messages, including emails and texts, "phishing" and engaging in other types of fraudulent or misleading practices. U.S. companies in particular can find CASL compliance to be unexpectedly onerous and complicated.



Most often companies run afoul of CASL by failing to obtain the consent of individuals to receive promotional emails and failing to comply with "unsubscribe" requirements in such emails. The fines for violating these and other requirements are significant: the Canadian Radio-television and Telecommunications Commission (CRTC), which is largely responsible for enforcing CASL, can impose fines of up to CAD$1 million on individuals and CAD$10 million on companies.

Recently, the CRTC held a corporate director personally liable for CASL violations. The CRTC found that the company sent electronic messages to individuals without having received their consent and that the unsubscribe mechanism in the commercial electronic messages did not comply with CASL. The CRTC imposed a $100,000 fine on the company's former president and CEO.

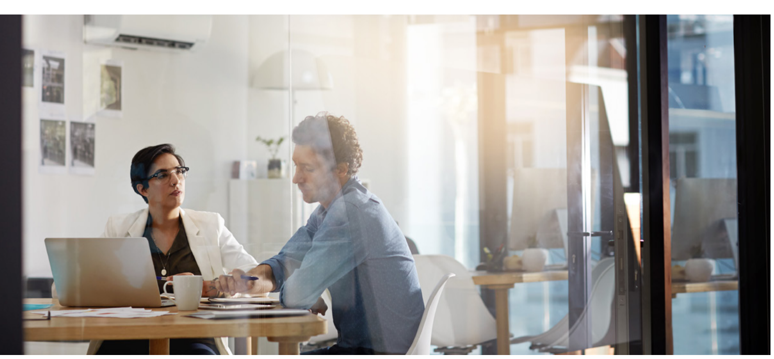
Before acquiring a Canadian company, U.S. companies should ensure that the target does not have a significant anti-spam compliance issue and is not vulnerable to one. Notably, this involves determining whether the Canadian company is transparent and honest in their electronic messaging, has the consent required to use its email lists as it does, and provides recipients with a clear and compliant way to opt out of future messages.

10

How do antitrust and foreign investment approvals work in Canada?

Certain large mergers in Canada (meaning the acquisition of a significant interest in the whole or a part of a business) may be subject to pre-closing notification requirements under Canada's Competition Act. The Commissioner of Competition (the "**Commissioner**") may challenge a merger (whether notifiable or not) if he or she believes that it is likely to prevent or lessen competition substantially in a relevant market in Canada. Such challenges are reviewed by the Competition Tribunal, which may issue orders dissolving mergers, divesting shares or assets, or preventing the transaction in whole or in part.

The *Competition Act* lists criteria that may be considered by the Competition Tribunal when determining whether a merger substantially lessens competition. These criteria generally correspond to those found in U.S. case law, although their application may be different. Because of the small size of the Canadian domestic economy, greater concentration may be acceptable in industries where even a relatively high percentage of the Canadian market would still not allow for optimal efficiency and international competitiveness.



The *Competition Act* also provides a specific "efficiencies defence" to anticompetitive mergers, which applies in cases where the efficiencies from the merger are likely to be greater than, and offset, the transaction's anticompetitive effects.

Mergers that meet a twofold test are subject to pre-closing notification requirements. Pursuant to the "size of parties test," the parties to the transaction, together with their respective affiliates (defined to include all entities joined by a 50%-plus voting link), must have assets in Canada or gross revenues from sales in, from and into Canada in excess of CAD$400 million in the aggregate. The "size of transaction test" is met where the Canadian assets or gross revenues from sales in and from Canada generated by such assets exceed a specific value threshold. The 2020 "size of transaction" threshold is CAD$96 million.

In general, and with certain exceptions, these asset and revenue values are calculated using book values based on the most recent audited financial statements for the relevant entity.

Where a proposed merger is subject to pre-merger notification under the *Competition Act*, the merging parties are required to obtain clearance before completion of the transaction. Clearance can take from two weeks (for non-complex matters) to many months for complex mergers.

FOREIGN INVESTMENT

Although Canada welcomes foreign investment, in some circumstances, non-Canadians are required to obtain prior approval from the applicable federal minister in order to effect an M&A transaction. For the purposes of the *Investment Canada Act*, "non-Canadians" include entities that are not controlled or beneficially owned by Canadians, including private equity funds that are organized or managed offshore.

Approval is contingent on demonstrating that the proposed transaction will likely be of "net benefit" to Canada.

A transaction may require pre-closing approval under the *Investment Canada Act* if, among other things, a non-Canadian entity acquires control (which is rebuttably presumed for this purpose at 33⅓% or more in the case of target corporations or more than 50% in the context of non-corporate entities) of a Canadian business and the applicable financial threshold is exceeded.

The applicable pre-closing review threshold varies on the basis of the nature and origin of the foreign buyer, as well as the nature of the business targeted by the acquisition. The review threshold is currently set at an enterprise value of CAD$1.613 billion (2020) for direct acquisitions by non-state-owned U.S. investors of non-cultural Canadian businesses.

All other acquisitions of Canadian businesses by U.S.-controlled entities are subject to post-closing notification. Transactions that raise potential Canadian national security issues may be subject to review regardless of whether the applicable financial or "control" threshold is exceeded.

The initial review period for applications is 45 days but that period can be (and usually is) extended unilaterally by the Minister for a further 30 days (and even longer if the investor consents). It is typical for a non-Canadian investor to agree to give written undertakings to the government of Canada to secure approval. Such undertakings often include commitments relating to employment and expenditures in Canada and Canadian participation in the business.

Some Canadian businesses are regulated by statutes that affect them uniquely and are therefore highly relevant to a potential acquirer. Banks and insurance companies, for example, have ownership limits imposed by law. Other businesses that are subject to a high level of regulation in Canada include, for example, the broadcasting and telecommunications industries.

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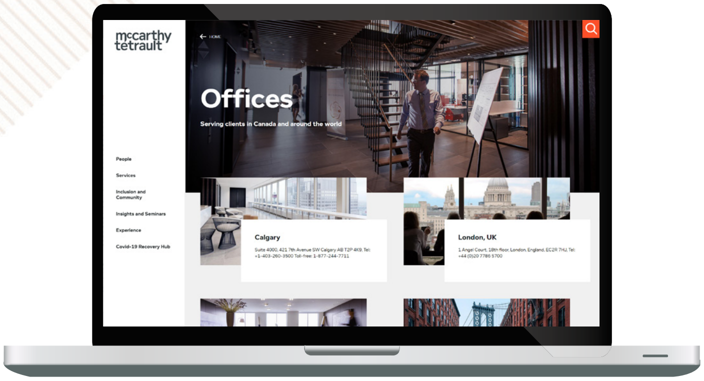
McCarthy Tétrault has worked with U.S. clients for generations, and this office builds on the firm's U.S. market presence to address the needs of the increasing number of U.S. clients looking to do business in Canada—particularly M&A, capital markets and private equity. It also allows our firm to deepen its existing relationships with U.S. law firms to better serve clients on cross-border issues.



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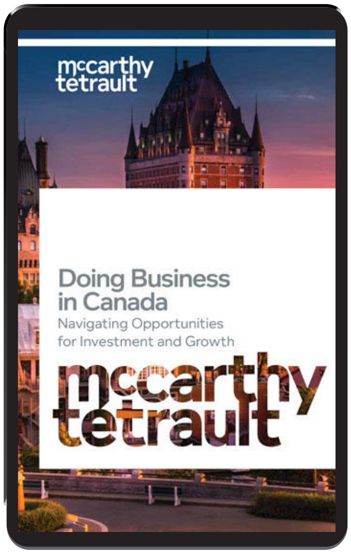
FURTHER READING

For a comprehensive guide on relevant laws and regulations that affect international investors pursuing Canadian business opportunities, download our latest edition of **Doing Business in Canada**

mccarthy.ca/en/insights/books-guides/latest-edition-doing-business-canada-available-now



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