PRIVATE EQUITY: FIVE TRENDS TO WATCH

With capital and credit waiting in the wings, the stage is set for an active year in Canada's PE market

BY JOHN CONNON; *GOODMANS LLP*

THE LARGE AMOUNTS of undeployed capital available to Canadian private-equity (PE) funds after a banner year of fundraising in 2013 and a renewed willingness by banks to extend credit on more favorable terms have set the stage for an active year in the Canadian PE market.

Here are five PE trends to watch for this year:

INCREASED RELIANCE ON REP & WARRANTY INSURANCE

Representation and warranty insurance (RWI) covers indemnification obligations arising from a breach of representations and warranties in a purchase agreement. RWI policy pricing is transaction-specific, but premiums are generally in the range of 2 to 4 percent of the coverage limit and deductibles are typically between 1 to 3 percent of the transaction value.

RWI benefits sellers and buyers in several ways:

- It lessens the seller's potential exposure in the event of a breach.
- It may reduce the need for capital clawbacks from investors to fund a successful claim.
- It can reduce or even eliminate the need for traditional means of securing indemnification obligations, such as depositing a portion of the sale proceeds into an escrow account. Minimizing the percentage of sale proceeds deposited into escrow helps maximize the seller's internal rate of return from the investment (an increasingly important metric for PE funds in the current competitive fundraising environment).
- Buyers looking to position bids in a competitive auction can seek a lower escrow or indemnity cap where RWI is in place.
- In the negotiation process, RWI can reduce friction between the parties by taking contentious issues such as escrows and indemnity caps off the table, or at least minimize their significance.
- RWI is particularly attractive where the seller's management retains an ongoing interest in the business by potentially eliminating the unpleasant scenario of having to seek recovery from management for a breach.

Although insurers have offered RWI for more than two decades, the use of RWI by both

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buyers and sellers has rapidly grown in recent years. Of the estimated 1,500 RWI policies issued worldwide over the last decade, approximately 45 percent were issued in 2012, according to the Aon Transaction Solutions Brochure (www.aon.ca). This trend continued in 2013, with a leading global insurer having issued more than twice as many RWI policies in 2013 in Canada and the US than in 2011. In absolute terms, Aon's North American team placed more than $3 billion of RWI coverage for 60 transactions in 2013, but this still represented a relatively small percentage of overall M&A volume. Aon estimates that RWI insurance was obtained for between just 6 to 8 percent of US transactions in 2013 and only 1 to 2 percent of deals in Canada. We expect further growth in RWI use in Canada as the market becomes more familiar with its benefits.

IMPROVED FUNDRAISING CLIMATE

Canadian private-equity funds reported record-breaking fundraising activity in 2013, surpassing strong fundraising in 2012 by more than three times. New capital totaling C$16.1 billion was committed to 35 PE funds during 2013, with C$10 billion raised in Q4 alone, according to a March 4, 2014 news release from Canada's Venture Capital & Private Equity Association, "Canada's Buyout Market in 2013: Moderate Growth, Record Breaking Fundraising." This follows on the heels of the industry's successful fundraising efforts in 2012, when a total of C$4.6 billion was committed to 27 domestic funds, up 24 percent from 2011. Given this abundance of "dry powder," we expect private-equity funds to actively seek opportunities to invest this capital in 2014.

EXIT OPPORTUNITIES IN 2014

Following a strong performance in 2012, the total number of PE fund realizations of Canadian portfolio companies slowed by approximately 16 percent through the first three quarters of 2013. Fortunately, a strong showing in the fourth quarter resulted in PE fund exits ultimately only being down by 5 percent year-over-year.

Amidst an overall slowdown in the Canadian IPO market, the "dual-track process" (where a seller simultaneously explores both an IPO and a negotiated M&A auction) has been followed less frequently by PE sellers, in part because IPO exits for Canadian private-equity-backed companies have been relatively infrequent and typically only partial exits. Since 2009, there have been only nine instances where a PE fund exited its investment by way of a Canadian IPO (see "Pitchbook 2013 Canada Private Capital Breakdown," May 22, 2013; online at www.pitchbook.com). This differs from the United States, where 57 PE-backed companies went public in 2013 alone – the highest number since 2006 – unlocking the second-highest amount of capital on record ($21.5 billion) (see Pitchbook Annual Report, "PE Breakdown 2014 Annual Report U.S. Edition," January 9, 2014; online at www.pitchbook.com).

Balanced against this slight slowdown in exits is the structural pressure on private-equity funds to realize on aging assets and return capital to their LPs. Many boom-era vintage funds are reaching the end of their terms. With each additional quarter, IRRs on many investments made before the global financial crisis are coming under downward pressure, even as valuations have started to increase. This has further enhanced the desire of PE funds to sell. PE funds are increasingly considering an exit from their investments through a sale to other PE funds, rather than selling to a strategic acquirer — the more traditional exit route.

While sales to strategic acquirers still accounted for a plurality of Canadian PE exits, with more than 40 percent of the total in 2013, this method of exit was down from 2012, when it constituted approximately 53 percent of the realizations (see Thomson Reuters for Canada's Venture Capital & Private Equity Association, "Canada's Buyout & Private Equity Market in 2013"; online at www.cvca.ca). Making up a portion of the difference were sales by PE funds to other financial investors, which increased from approximately 11 percent in 2012 to 18 percent in 2013.

Global secondary buyout activity remained essentially unchanged in 2013, both in terms of the number of overall deals (481 in 2012 versus 480 in 2013) and realized investments ($77.5 billion in 2012 versus $78 billion in 2013), according to Pitchbook, "PE Capital Invested Jumps 13% in 2013" (January 7, 2014); online at www.pitchbook.com. After a particularly strong 2012, the pace of US secondary buyouts slowed in 2013, with overall deal value falling to $79.8 billion, a 7.6 percent drop from 2012 ($86.4 billion). The substantial number of PE fund exits into the buoyant US IPO market in 2013 likely accounts for some of this reduction. While the Canadian private-equity market has lagged the US in secondary buyout exits (as noted above, only 18 percent of Canadian PE exits were to financial buyers in 2013), the combination of (i) newer funds having access to substantial amounts of capital, (ii) older funds reaching the ends of their terms, and (iii) the US market trends suggest that secondary buyouts may become increasingly common in Canada in 2014.

USE OF SANDBAGGING PROVISIONS

The volume of private M&A activity in the United States dwarfs that in Canada, with the result that certain deal points often take longer to become "market" in Canada. One of these points is whether or not to include "sandbagging" provisions in purchase agreements. These provisions address the impact that a buyer's knowledge of a breach will have on its ability to assert a post-closing indemnity claim against a seller. A "pro-sandbagging" provision generally provides that a buyer's knowledge of a breach will not affect its right to seek indemnification and is obviously more favorable to the buyer. Sellers, on the other hand, would prefer an "anti-sandbagging" clause, which prohibits buyers from making claims if they had pre-closing knowledge of the breach.

The inclusion of pro-sandbagging provisions has held relatively constant in the US over the last several years (according to the 2013 ABA Private Target M&A Deal Points Study, 41 percent of private M&A transactions surveyed included such a provision), but only recently have a significant number of Canadian agreements followed suit. The 2012 ABA Canadian Private Target M&A Deal Points Study indicates that 24 percent of the surveyed transactions included a pro-sandbagging provision, more than twice the percentage disclosed in the 2010 Canadian study. In 2012, 9 percent of Canadian agreements included anti-sandbagging provisions, down from 21 percent in 2010 but still almost double the corresponding statistic in the 2011 US study. The remaining 67 percent of Canadian private M&A agreements were silent on the point, compared with 54 percent in the US.

A contributing factor to the greater prevalence of these provisions in US agreements may be the greater volume and the continuing evolution of American jurisprudence on the subject. Under applicable Delaware and New York state case law, for example, a buyer is generally not required to demonstrate reliance in order to maintain a breach of representation claim. By contrast, California courts have taken the view that a buyer must be able to demonstrate reliance in order to support such a claim. Even within the leading commercial jurisdictions of New York and Delaware, the case law is not completely settled and there have been a number of exceptions to these general principles over the last two decades. Accordingly, a substantial percentage of American transactions have sought to provide greater clarity and certainty for the buyer and the seller with respect to sandbagging by including specific provisions in the purchase agreement.

There is no established case law on sandbagging in Canada and the law in the area is unsettled. It seems clear that a buyer could sue and win if a contractual warranty proved false, with or without reliance (see, for example, John McCamus, *The Law of Contracts*, 2d ed. (Toronto: Irwin Law Inc., 2012) at 736).

However, a seller in such a situation may be able to claim that the buyer lacked good faith if it had knowledge of the breach prior to closing and failed to warn the seller. Pleadings to this effect were struck by the motions judge in *Transamerica Life Canada Inc. v. ING Canada Inc.*, [2003] 68 O.R. (3d) 457 (C.A.), finding that the parties – two sophisticated insurance companies both represented by major Toronto law firms – did not intend to imply a duty of good faith in their contract. The motion judgment, however, was overturned by the Ontario Court of Appeal finding that the unsettled state of the law warranted inquiry by a trial judge. Ultimately, this case was resolved by the parties prior to trial, so the law of implied duties of good faith continues to remain unclear in Canada.

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WAIVER OF CORPORATE OPPORTUNITIES DOCTRINE

The doctrine of corporate opportunities is well-established in both Canada and the US. The doctrine provides that directors and officers cannot personally profit from an opportunity presented to them in their role on the board of a corporation. If a director or officer is found to have improperly taken an opportunity that rightly belonged to the corporation, he or she must disgorge to the corporation any profit received as a result.

For the PE investor whose employees typically sit as directors on boards of its portfolio companies, this doctrine is potentially problematic for a number of reasons. In the course of its business, a PE fund could be presented with business opportunities that may be attractive to one or more of its portfolio companies engaging in similar businesses. If the PE investor has investments in more than one such portfolio company, it could quickly find itself in the untenable position of having to disclose and present the same opportunity to all such portfolio companies. Delaware sought to address this concern in 2000 by amending its *General Corporation Law* to permit Delaware corporations to renounce, in their certificate of incorporation or by action of its board of directors, their interest or expectancy in specified classes of business opportunities presented to them or to one or more of their officers, directors or stockholders.

Since Delaware adopted this amendment, it has become commonplace for US PE funds to include an advance waiver of the corporate opportunities doctrine as a condition to the closing of their investments. US funds are also increasingly requesting advance waivers when making investments into Canadian corporations. It is not clear whether such waivers would be enforceable under Canadian law absent an equivalent amendment to Canadian corporate statutes. While PE investors may be insisting on, and receiving, these waivers from their Canadian portfolio companies more frequently, there remains risk that the corporate opportunities doctrine will nonetheless continue to apply to them.

John Connon
Goodmans LLP

Tel: (416) 597-5499
Fax: (416) 979-1234

jconnon@goodmans.ca

» John Connon is a partner specializing in private equity, public and private mergers and acquisitions, corporate finance and securities law. From 1998 to 2004, John was an associate in the New York, Hong Kong and London offices of Paul, Weiss, Rifkind, Wharton & Garrison LLP. John was named one of *Lexpert*®'s "Rising Stars: Leading Lawyers Under 40" in 2008. Admitted to the Ontario Bar in 2005 and to the New York Bar in 1999.