Goodmans LLP

# Structuring Private M&A Transactions in Canada

## Overview

Canada, like its neighbors to the south, experienced a record-breaking M&A environment in 2021. Transaction activity increased across the board, with significant growth particularly in the mid-market segment. While 2022 has seen a global cool down in M&A activity, we believe this "break" will be short lived. A significant amount of Canadian M&A activity continues to be driven by non-Canadian buyers and, in particular, U.S. based private equity purchasers. Below we explore certain considerations relevant to acquiring a privately held Canadian business.

## Deal Structure

Canadian M&A transaction structure largely depends on tax implications and bargaining power. Similar to many other jurisdictions, share sales generally benefit Canadian sellers since sale proceeds receive "capital gains" treatment. Only 50% of these amounts are taxable, and in some private transactions can be completely tax-free (up to a limit of just less than C$1 million per seller). Conversely, an asset sale is generally advantageous for buyers, providing a step-up in the tax cost of the acquired assets facilitating certain tax deductions for depreciation, among other potential non-tax benefits.

A non-Canadian buyer acquiring a Canadian business would typically do so through a newly-formed Canadian entity. On a share purchase, this newly formed entity would often amalgamate (the Canadian equivalent of a merger) with the Canadian target immediately post-closing. One of the primary purposes of this structure is to ensure the buyer has shares with paid-up capital for Canadian tax purposes. Paid-up capital is valuable because it can facilitate cross-border distributions without Canadian withholding tax, whereas dividends are subject to withholding tax. This structure also facilitates the deduction of interest on acquisition financing against the target business's operating income. Canada does not have tax consolidation, so any acquisition financing would be borrowed by the new Canadian entity that amalgamates with the target to ensure interest is paid by the entity earning the business income. Debt financing arrangements can have other Canadian tax implications, including those related to transfer pricing, withholding tax, Canadian "thin capitalization" rules and potential limitations on aggregate interest and financing expense deductions, and should be socialized with tax advisors at the onset of any transaction.

## Vendor Roll-Overs

Complexities arise when non-Canadian buyers use equity consideration when buying a business from Canadian sellers. The sale of shares of a Canadian company by a Canadian in exchange for equity of a non-Canadian buyer results in tax being payable on any gain inherent in the shares. In other words, a tax deferral (or "roll-over" treatment) is not available where the consideration consists of equity of a non-Canadian entity.

To address this issue and achieve tax deferral, non-Canadian buyers may consider an "exchangeable share" structure. An exchangeable share is a security of a Canadian corporation, usually established as a subsidiary of the non-Canadian buyer, designed to mirror the equity securities of the non-Canadian parent. This is achieved through a number of features, including the right to exchange the shares of the Canadian corporation for equity securities of the non-Canadian parent and the replication of all rights attaching to the equity of the non-Canadian parent (including dividends, liquidation entitlements, voting, etc.).

## Post-Closing Purchase Price Adjustments

In Canada, the most commonly used post-closing purchase price adjustment mechanism continues to be the traditional working capital adjustment. However, in recent years the Canadian market has seen a marginal increase in the "locked-box" construct. Popular in Europe, a locked box mechanism provides for the equity price of a business to be calculated using a recent historical balance sheet. Once the "effective date" has been set and the locked box price calculated, there are no post-closing adjustments other than for defined "leakage". Effectively, the locked-box construct passes economic risk of the business to the buyer at a point in time before closing.

## Representation and Warranty Insurance / Indemnification

Canada continues to see an increased use of representation and warranty insurance ("**RWI**") in private M&A transactions. Given the popularity of RWI, Canada also continues to experience an increase in "no liability" or "public-company style" sale constructs. Where RWI is not used or deal-specific risks are identified, escrows or holdbacks continue to be the primary risk mitigation tool used by buyers.

## Interim Operating Covenants

Historically, the Canadian approach to negotiating interim operating covenants and related termination rights followed the U.S. practice. This may change following the recent decision of a Canadian Court in *Cineplex v. Cineworld*[1], which offers an interesting contrast to a Delaware Court's decision in *AB Stable v. MAPS Hotel and Resorts*.

Both cases involve a buyer claiming it was not required to close a transaction because Covid-related actions taken by the seller between signing and closing were breaches of the ordinary course covenant. But there the similarity ends. While the Court in *AB Stable* held that the seller breached the ordinary course covenant and the buyer did not have to close the transaction, the Court in *Cineplex* found the seller had not breached the ordinary course operating covenant, and was entitled to damages in excess of C$1.2 billion.

While the distinction could be explained on the facts, the *Cineplex* decision, currently under appeal, has brought renewed focus to these provisions in Canadian M&A agreements, and should be a key consideration for any non-Canadian buyer looking to acquire a Canadian business, which will have implications on transactions long after the Covid era is behind us.

## Governing Law

In Canadian deals, the primary location of the seller's business typically dictates the governing law of transaction documents. Non-Canadian buyers sometimes push for foreign governing law and/or jurisdiction for disputes, particularly where the buyer's financing arrangements are governed by non-Canadian law. Canadian sellers generally resist this.

[1] Goodmans LLP is acting for Cineplex in the litigation, and also acted for Cineplex on the transaction.

## Regulatory Considerations

Acquisitions of (or investments in) Canadian businesses by non-Canadians are governed by the *Investment Canada Act* (the "**ICA**"). The ICA requires non-Canadian buyers to file a notice with the Canadian government, and provides the government with the ability to review transactions. Certain very large transactions are subject to suspensory reviews in which the investor must demonstrate that its acquisition is of "net benefit" to Canada. The Canadian government also has discretion to review transactions on national security grounds. National security reviews are typically based on considerations resulting from the identity of a foreign buyer or sensitivity of a Canadian asset or business. In transactions more likely to attract national security scrutiny – based on either the subject matter of the transaction or the identity of the purchaser – parties can eliminate the risk of a post-closing national security investigation by completing the ICA notification process before closing.

In addition, parties to a Canadian M&A transaction must notify the Canadian Competition Bureau of their planned transaction if two tests are met:

- ***Size of parties.*** The buyer, the seller and their affiliates have Canadian assets or revenue exceeding C$400 million.
- ***Size of transaction.*** The target has Canadian assets or revenue exceeding a prescribed amount, currently C$93 million.

The actual application of these tests is complex, and legal advice must be sought in how they are applied. In addition, even if the above tests are not triggered, the Canadian Competition Bureau can challenge transactions that substantially lessen competition in Canada, including by forcing divestitures post-closing. The Canadian Competition Bureau also has discretion to review commercial agreements among competitors, such as joint ventures, exclusive supply agreements, and settlement agreements, and may seek to challenge agreements that it determines have anticompetitive effects.

Given the above, it is important for non-Canadian buyers to have a customized regulatory strategy. Buyers should complete an early assessment of regulatory risks, and devise appropriate ways of addressing these issues in advance to minimize post-closing risk, including potential divesture orders.

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