Takeover Bids in Canada and Tender Offers in the United States

Torys provides comprehensive guidance on cross-border bids and tender offers.

Takeover Bids in Canada and Tender Offers in the United States

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 takeover bids in Canada and tender offers in the United States.

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 takeover bids or tender offers. 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

In the world of mergers and acquisitions, the border between Canada and the United States is virtually invisible, with M&A activity between the two countries fuelled by economic, political and geographical drivers. Canada is a relatively appealing source of target companies for U.S. businesses because of its physical proximity, cultural and regulatory similarities, minimal geopolitical risk and wealth of natural resources. At the same time, Canadian companies seeking to be global players—or otherwise grow significantly—naturally look for acquisition opportunities in the much larger U.S. market.

This guide focuses on cross-border transactions structured as takeover bids in Canada or tender offers in the United States. Takeover bids and tender offers involve an acquiror making an offer to target shareholders to acquire some or all of their shares. In a hostile situation, a takeover bid or tender offer is the only way to acquire a Canadian or U.S. target company. In a friendly situation, many variables will influence if this is the best way to acquire a target, compared with a merger (in the United States) or an amalgamation or plan of arrangement (in Canada). The most appropriate form of transaction will often become apparent during planning or negotiations and will depend on 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, among other factors.

This guide provides a side-by-side review of the Canadian and U.S. legal regimes governing takeover bids and tender offers to help acquirors and targets prepare for a cross-border bid. The general principles underlying Canadian and U.S. takeover laws are the same, as are the practical effects of many specific rules of each jurisdiction. Both legal regimes are designed to provide fair and even-handed treatment of target shareholders by ensuring that they are all offered the same consideration and given full disclosure of all material information pertaining to a bid. A secondary objective of both legal regimes is to provide a predictable set of rules and a level playing field for potential bidders, targets and other capital markets participants.

Generally speaking, takeover bids for Canadian targets must comply with Canadian law and tender offers involving U.S. targets must comply with U.S. law. The regulatory situation may be more complicated, however, if a target has a significant number of shareholders in both jurisdictions. In those cases, a bid may have to comply simultaneously with both the Canadian and U.S. legal regimes.

This guide focuses on the law governing corporate entities. The principles governing other entities are substantially similar. In the case of non-corporate entities such as income trusts and REITs, the constating documents (e.g., the declaration of trust), as well as principles of trust law, will be applicable.

Regulatory differences at a glance

Despite many similarities between Canadian and U.S. legal regimes, the details and terminology of some of the legal requirements differ. These are some of the main differences:

- The Canadian takeover rules are triggered when an acquiror crosses a bright-line 20% threshold ownership of a class of shares in a target company. U.S. tender offer rules are triggered by widespread solicitation of public shareholders combined with other qualitative factors, and open market purchases are not generally considered to be tender offers.
- Prospectus-level disclosure is required in both jurisdictions if an acquiror offers securities as consideration; under the U.S. rules, this disclosure may be subject to intensive review by the U.S. Securities and Exchange Commission, which could significantly affect the timing of the transaction.
- Canada's early warning rules require a toehold position to be publicly disclosed when the acquiror's ownership exceeds 10%—and following this disclosure, further purchases must be halted until one business day after the necessary regulatory filings are made. The U.S. early warning rules require a toehold position to be disclosed when the acquiror's ownership exceeds 5%.
- The minimum tender condition for a bid, which will reflect the applicable corporate law requirements for a second-step squeeze-out merger in the target's jurisdiction of incorporation, is typically ⅔ for Canadian targets or a majority of the target's shares for U.S. targets.
- If a bidder does not reach a 90% ownership level in a bid for a Canadian target, a second-step shareholders' meeting to approve the transaction will be required, whereas in a bid for a U.S. target incorporated in Delaware, a second-step shareholders' meeting would not be required as long as the bidder reaches majority ownership and certain other requirements are met.
- Stronger and more effective takeover defences have historically been permitted under the U.S. regime, meaning that Canadian companies have been somewhat easier targets for unsolicited bids, although this difference is becoming less pronounced as a result of various developments on both sides of the border.
- Under the *Competition Act*, Canadian pre-merger notification requirements will be triggered by a bid for more than 20% (or 50% if the bidder already owns more than 20%) of the target's voting shares and the assets or revenues of the merging parties exceed certain thresholds; in the U.S., the pre-merger notification requirements under the *Hart-Scott-Rodino Antitrust Improvements Act of 1976* may be triggered by the acquisition of a certain dollar value of securities, regardless of the percentage of target securities acquired.
- In Canada, foreign investment by a non-Canadian may be subject to national security or economic "net benefit" reviews under the *Investment Canada Act*. In the United States, foreign investments by non-Americans may be subject to review on national security or other defence-related grounds.

Parties in cross-border bids must determine whether both Canadian and U.S. takeover rules will apply or whether an exemption is available from some or all of one country's requirements. In cases of dual regulation where no exemption is available, the parties will have to quickly become familiar with both sets

of laws and comply with the stricter requirements. Parts 4 and 5 of this guide provide an overview of both Canadian and U.S. takeover rules for cross-border transactions. Part 9 of this guide describes the various exemptions that may be available, depending on the circumstances, to allow the parties to avoid dual regulation. Thorough preparation and planning will enable all parties to effectively navigate any applicable requirements and structure and execute their cross-border transactions as smoothly and efficiently as possible.

2

The lay of the land

Triggering the Canadian and U.S. legal regimes

Target shareholders in Canada

Takeover bids in Canada are governed by the corporate law of the jurisdiction in which the target is located and the securities laws of each province and territory where target shareholders are located. For example, Ontario laws will apply if a takeover bid is made to Ontario shareholders of a target company. If a bid is also made to shareholders in other provinces or territories, as would typically be the case, it will be subject to the securities laws of those jurisdictions. In describing Canadian legal requirements, this guide focuses on the requirements under Ontario corporate and securities laws, which are largely harmonized with those of the other provinces and territories.

The Ontario takeover bid rules are triggered when an acquiror (with any joint actors) crosses a threshold of 20% ownership of a class of a target's outstanding voting or equity securities. If the rules are triggered, the acquiror must make the same offer to all of the target's shareholders by sending them a formal takeover bid circular, unless an exemption is available.

In measuring its existing ownership of the target's securities, an acquiror must include securities that it beneficially owns or exercises control or direction over. Any securities that an acquiror has the right to acquire within 60 days, including upon exercise of options, warrants or convertible securities, are deemed to be beneficially owned by the acquiror. The holdings of any other party that is acting jointly or in concert with the acquiror must also be included.

Under Ontario law, whether a person or entity is "acting jointly or in concert" with the bidder will generally depend on the facts and circumstances of the particular situation, subject to the following:

- An affiliate is deemed to be acting jointly or in concert with a bidder, as is any party that, as a result of any agreement, commitment or understanding with the bidder or any joint actor, acquires or offers to acquire securities of the same class as those subject to the bid.
- Certain other parties, including associates and anyone exercising voting rights with the bidder, are presumed to be acting jointly or in concert with the bidder, although the presumption can be rebutted on the basis of the facts and circumstances.

There are several statutory exemptions from Ontario's takeover bid rules. Private agreements to purchase securities from not more than five persons are exempt. If there is a published market for the target's securities, the price under this exemption may not exceed 115% of the market price. In addition, normal-course purchases of up to 5% of a class of a target's securities during any 12-month period are also exempt.

The price paid for securities under this exemption may not be greater than the market price of the securities on the date of acquisition. Discretionary exemptions from the bid rules may be applied for and obtained from the regulators if circumstances warrant.

Target shareholders in the United States

Tender offers in the United States are governed by U.S. federal securities laws and related rules of the Securities and Exchange Commission (SEC), as well as by the corporate laws of the target's jurisdiction of incorporation. In describing U.S. corporate legal requirements, this guide focuses on the corporate laws of Delaware because a significant number of U.S. public companies are incorporated there.

The U.S. tender offer rules generally apply when the target's equity securities are listed on a U.S. stock exchange or widely held, meaning that they are registered with the SEC under the *Securities Exchange Act of 1934* (Exchange Act). The U.S. anti-fraud provisions and certain rules pertaining to the fairness of the transaction apply to all U.S. tender offers.

Instead of a bright-line quantitative test equivalent to Canada's 20% threshold, an eight-factor qualitative test is applied to determine whether a transaction triggers the U.S. tender offer rules. Each of the following eight factors is relevant, but not individually determinative:

1. The bidder makes an active and widespread solicitation of public shareholders.
2. The solicitation is for a substantial percentage of the target's stock.
3. The offer is at a premium above the prevailing market price.
4. The terms are firm rather than negotiable.
5. The offer is contingent on the tender of a fixed minimum number of shares.
6. The offer is open for a limited period of time.
7. Shareholders are subject to pressure from the bidder to sell their stock.
8. The public announcement of a purchasing program is preceded or accompanied by a rapid accumulation of target company securities.

The consequences of triggering the U.S. tender offer rules are essentially the same as the consequences of triggering the Canadian rules: the acquiror must make the same offer to all target shareholders by way of formal documentation mailed to shareholders and filed with securities regulators.

Cross-border exemptions

Some transactions may simultaneously trigger the Canadian takeover bid rules and the U.S. tender offer rules. A bid for the shares of a Canadian company that has a significant number of U.S. shareholders could trigger both countries' rules unless an exemption is available from the U.S. rules. Conversely, a tender offer for the shares of a U.S. company that has a significant number of Canadian shareholders could trigger both countries' rules unless an exemption is available from the Canadian rules. Where the two legal regimes

impose different requirements, a transaction that is subject to both regimes will have to comply with the more stringent rules unless discretionary exemptive relief is obtained from the applicable regulatory authority.

Canadian and U.S. securities regulators have adopted cross-border exemptions so that a takeover bid may proceed primarily under the laws where the target is organized, even if the target has shareholders residing in both jurisdictions. If a cross-border exemption is available, the parties to the transaction will save time and avoid duplicative regulation. A tender offer for the shares of a U.S. target company with less than 40% of its shareholders residing in Canada will usually be exempt from most of the Canadian rules, and a takeover bid for the shares of a Canadian target company with less than 40% of its shareholders residing in the United States will usually be exempt from most of the U.S. rules. These cross-border exemptions from regulation are discussed in greater detail in part 9, "Avoiding Dual Regulation: Cross-Border Exemptions."

Disclosure liability

Under Canadian and U.S. law, acquirors' and targets' public communications about a bid, whether oral or written, are heavily regulated and subject to liability that may involve private plaintiffs, securities regulators or both. Substantial due diligence is usually required to help ensure that the parties' disclosure to the market and in filings with securities regulators is accurate and not misleading.

Alternatives to a bid

There are advantages and disadvantages to takeover bids and tender offers when compared with alternative ways of acquiring a target. The best form of transaction will often become apparent in the planning or negotiating phase, depending on a myriad of factors, including the speed with which the acquiror wants to gain control of the target, the tax implications of the various structures, the available methods of financing the transaction, potential regulatory hurdles such as antitrust review and the target's receptiveness to an acquisition.

In a friendly deal in Canada, a takeover bid may offer a slight timing advantage to obtain control of a target because the target's board may voluntarily shorten to as little as 35 days the minimum bid period of 105 days that would otherwise apply. In the U.S., a tender offer is the fastest way to obtain control of a target. In both jurisdictions, a takeover bid or tender offer is the only way to acquire a hostile target because the offer is made directly to the target's shareholders, thereby bypassing its management and board of directors. However, if an acquiror does not obtain sufficient tenders to complete a compulsory acquisition of shares, a second-step merger to acquire any untendered shares involving a shareholders' meeting will be required. This could eliminate any timing advantage of friendly takeover bids and tender offers, as compared to single-step plans of arrangement and mergers, in obtaining full ownership of the target. Under Delaware law, a second-step shareholders' meeting to approve the transaction may not be required if the bidder obtains majority ownership in the target following the tender offer. A tender offer, therefore, will likely be the fastest way for an acquiror to obtain 100% ownership of a Delaware target.

In Canada, amalgamations and plans of arrangement are the main alternative to takeover bids. Both these options require a target shareholders' meeting and supermajority approval of the transaction by not less

than ⅔ of the votes cast at the meeting. A single-step merger in the United States is equivalent to an amalgamation in Canada. A merger generally requires approval by a majority of the outstanding shares of the target and is the primary alternative to a tender offer.

A plan of arrangement is a very flexible way to acquire a Canadian company. This method requires court approval following a hearing and although this may provide a forum for disgruntled stakeholders to air their grievances, a plan of arrangement allows the parties to deal with complex tax issues, amend the terms of securities (such as convertibles, exchangeables, warrants or debentures) and assign different rights to different holders of securities.

Plans of arrangement 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. If an acquiror is offering securities to target shareholders as consideration, plans of arrangement have the added benefit of being eligible for an exemption from the associated SEC registration and disclosure requirements.

Takeover bids and tender offers may be more difficult to finance than other kinds of transactions. If the acquiror does not obtain sufficient tenders to complete a compulsory or short-form second-step merger to acquire any untendered shares, the acquiror may find it difficult to secure financing. By contrast, in the case of a plan of arrangement or merger, assuming the requisite shareholder vote is obtained, the acquiror can immediately secure the financing with a lien on the target's assets, since the acquiror will own 100% of the target at the time it needs to pay the target's shareholders.

In Canada, amalgamations and plans of arrangement are permitted to be subject to a financing condition, whereas takeover bids are not; however, the target's board will generally insist on financing being in place for a plan of arrangement (financing conditions are discussed further in the section "Conditions" in part 4 "The rules of the road").

Friendly versus unsolicited transactions

A key variable in structuring any takeover bid or tender offer is whether the transaction is friendly or unsolicited. Although unsolicited transactions often result in a change of control, the initial unsolicited bidder is often not the successful party. In an unsolicited transaction, the highest price usually wins. In Canada, most friendly transactions proceed by plan of arrangement, rather than by takeover bid, given the flexibility provided by that structure.

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 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.

- A friendly acquiror can obtain access to confidential information for due diligence purposes, whereas in an unsolicited situation, access will not be granted unless necessary for the target's board to fulfill its fiduciary duties to target shareholders.

- A friendly acquiror can obtain a "no shop" covenant, which prevents a target from soliciting competing offers (subject to a "fiduciary out") so that only serious third-party bidders are likely to interfere with the transaction.

- 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.

- Friendly transactions avoid acrimony and preserve relationships.

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 will likely seek a higher price as a condition of making a favourable recommendation to target shareholders.

- 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 negotiations, causing a run-up in the target's stock price and potentially making the deal more expensive.

Going-private transactions

The term "going-private transaction" 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 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, going-private transactions involve inherent conflicts of interest and inequalities of information. To protect public shareholders in these circumstances, both Canadian and U.S. laws prescribe heightened legal requirements when a takeover bid or tender offer is also a going-private transaction. These rules are set forth primarily in *Multilateral Instrument 61-101 - Protection of Minority Securityholders in Special Transactions*, in Ontario, Quebec, Alberta and certain other provinces, and Rule 13e-3 under the U.S. Exchange Act.

For a takeover bid that is subject to these rules, MI 61-101 generally requires:

- A formal, independent valuation of the target's shares, which must be supervised by an independent committee of the target's board.
- Heightened disclosure, including detailed disclosure of the background to the bid and any other valuations prepared or offers received for the target's securities in the past two years.

A bidder will also be required to obtain minority shareholder approval of a second-step transaction if it wants to acquire full ownership of the target, as will usually be the case. The bidder may, however, count shares tendered to its bid toward that approval if certain conditions are satisfied (see part 5 "Second-step transactions").[1]

Like MI 61-101, Rule 13e-3 under the U.S. Exchange Act also imposes heightened disclosure requirements for going-private transactions.[2] Detailed information is required about the target board's decision-making process, the rationale and purpose of the transaction, the alternatives considered by the board and other offers received for the target's securities during the past two years. The board and affiliates of the target that are engaged in the going-private transaction must also explain the reason why the transaction is considered fair to target shareholders and must file with the SEC supporting information such as prior appraisals or opinions, as well as informal materials like presentations to the board by investment bankers.

In contrast to MI 61-101, no formal valuation is required under Rule 13e-3. However, the target's board will typically form a special committee to review the transaction and will also request a financial adviser to provide a fairness opinion to support the board's exercise of its fiduciary duties (see part 6 "The target's board of directors"). Moreover, these transactions are subject to review by the SEC.

In the context of private equity buyouts of public companies, the heightened legal requirements applicable to going-private transactions give rise to timing and process considerations. If a going-private transaction 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), minority approval and a formal valuation may be required under MI 61-101. Furthermore, under U.S. rules, both the target and each acquiror that is considered an affiliate of the target would be subject to the heightened disclosure obligations of Rule 13e-3 and be required to provide, among other things, information about the fairness of the transaction and plans for the target.

The factual circumstances that could trigger the going-private rules are very similar in Canada and the United States, but subtle differences in the legal tests could result in one jurisdiction's rules being triggered but not the others. Companies should seek advice at an early stage about a transaction's potential to engage the going-private rules and strategies that can be used to avoid triggering them inadvertently.

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[1] For a going-private transaction structured as an amalgamation or plan of arrangement, MI 61-101 similarly requires approval by a majority of the minority shareholders.

[2] Rule 13e-3 applies only when the target's securities are listed on a U.S. stock exchange or otherwise registered with the SEC. Furthermore, an exemption is available if the number of securities held by U.S. holders is relatively small.

3

Pre-transaction issues

Insider trading

At the very outset of a potential transaction in either Canada or the United States, 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) and in Rules 10b-5 and 14e-3 under the U.S. Exchange Act.

Any purchases or sales of target securities during the six months leading up to a Canadian takeover bid[3] or during the 60 days leading up to the announcement of a U.S. tender offer must be disclosed in the documentation filed with securities regulators and mailed to shareholders. This disclosure requirement covers trading by the parties to the transaction, their executive officers and directors, and various other persons and entities connected to the parties, depending on the circumstances.

Public disclosure about a bid

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. Parties to a deal will want to conduct themselves and manage any negotiations in a way that will minimize the risk of a disclosure obligation crystallizing when such an announcement would be premature or would jeopardize the transaction. The question of when to publicly announce a transaction is a complex matter of judgment that should be discussed with advisers.

Canadian public companies must promptly announce any material change in their business or affairs in a news release, and they must file a material change report with securities regulators within 10 days of the change. Determining when a material change has occurred in the context of a friendly deal is difficult. The Ontario Securities Commission noted, in *Re AIT Advanced Information Technologies Corp.*, that an important factor in determining whether a material change has occurred is whether both parties are

[3] Twelve months in the case of a takeover bid made by an insider.

committed to proceeding with the transaction and whether there is a substantial likelihood that the transaction will be completed.[4]

U.S. domestic companies are not always obliged to disclose material changes as promptly as is required by Canadian law. Instead, U.S. companies are generally entitled to keep material corporate developments confidential until a specific event triggers a disclosure obligation. In the M&A context, entering into a “material definitive agreement” triggers an obligation for U.S. domestic companies to file a report on Form 8-K disclosing the transaction.

Until a 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. This is known in the United States as the “abstain or disclose” rule. 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 in both Canada and the United States.

Acquiring a toehold

The potential advantages of acquiring target stock before proceeding with a bid are the same in Canada and the United States:

- Market purchases may be made at prices below the formal offer 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 bidders in a contested deal.
- It may allow the bidder to profit from a run-up in the target share price if a competing bidder acquires the target.

Toehold acquisitions are more popular in Canada than in the United States because of the greater risk in the United States of a target’s takeover defences effectively preventing a change of control and leaving the

[4] In Canada, a material change report may be filed confidentially if the company reasonably believes that publicly disclosing the information would be unduly detrimental. Whether it is advisable to file confidentially will depend heavily on the facts and circumstances. In the United States, the SEC does not permit confidential material change filings; instead, most cross-listed Canadian issuers that make confidential filings in Canada do not have to make any SEC filing until the information is released publicly in Canada. We believe that filing confidentially in Canada without the availability of a comparable procedure in the United States entails risks for cross-border companies under the U.S. civil liability regime. Companies should consult counsel as early as possible to help determine the best course of action.

acquiror with an unwanted block of stock (see part 6 “The target’s board of directors” for a comparison of Canadian and U.S. takeover defences).

When acquiring a toehold, bidders must be aware of the Canadian “pre-bid integration” rules that apply to takeover bids. 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. As a partial exception to this rule, a formal bid may include shares as part of the consideration even if cash was paid in the pre-bid purchase, but in that case, shareholders must be given the option of electing all-cash consideration.

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

- Securities acquired before a takeover bid do not count toward the 90% minimum that the acquiror needs to entitle it to acquire the remaining target shares in a second-step transaction without a shareholder vote.
- If a shareholder vote is required to approve a second-step transaction, securities acquired before the bid must be excluded in determining whether the necessary supermajority shareholder approval has been obtained (see part 5 “Second-step transactions”).
- Toehold shares do not count towards the 50% minimum tender condition for a takeover bid.
- 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 the deal falls away and no competing acquisition is completed, the toehold acquiror may be left with a stranded position.

In the United States, shares acquired in a toehold will count toward the minimum tender condition and, assuming the toehold itself is not deemed to be a tender offer based on the factors enumerated on pages 5 and 6, there would be no U.S. equivalent to Canada’s pre-bid integration rules that would apply. However, in both jurisdictions, any pre-bid transactions in a target’s securities will have to be fully disclosed in the bid documentation.

Early warning disclosure

Any purchase of target securities before a bid is commenced could trigger an early warning disclosure requirement. Like the takeover rules generally, the Canadian early warning requirements apply to voting or equity securities of a target, whereas the equivalent U.S. beneficial ownership reporting rules apply only to voting equity securities that are registered under section 12 of the Exchange Act—that is, listed or widely held securities.

The disclosure requirement is triggered when the acquiror (including others acting together with the acquiror) crosses the 10% level in Canada or the 5% level in the United States. If a formal bid by another bidder is already outstanding, the Canadian threshold becomes 5%. If a target is listed on both a Canadian and a U.S. stock exchange, the lower U.S. reporting threshold of 5% will apply.

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 stock until one business day after the report is filed unless it already owns 20% or more of the stock. 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 stock will trigger further disclosure.

In the United States, a bidder must file a beneficial ownership report with the SEC within five business days of acquiring more than 5% of a target's securities and disclose any plans or proposals with respect to the target. Any material change in the facts disclosed in the report will trigger a requirement for amended filings and any such amendment must be filed within two business days with the SEC. A purchase of an additional 1% of the target's stock is deemed to be a material change for this purpose. If a bidder was previously a passive investor, a new report must be filed within five business days of the bidder changing its investment intent regarding the target's securities and there will be a 10-day cooling-off period after the new filing is made, during which the bidder may not vote or acquire additional target securities.

Lockup agreements

Lockup agreements with major target shareholders to secure their participation in a bid are common in both Canada and the United States. Entering into a lockup agreement is an alternative to acquiring a toehold in the open market or entering into a private agreement to acquire target shares in advance of a formal offer. Under a lockup agreement, an acquiror may agree to pay more than the 15% premium permitted under Canada's private agreement exemption as long as it offers identical consideration to all target shareholders. In both jurisdictions, locked-up shares may be counted for purposes of determining whether an acquiror has reached the minimum ownership level needed to complete a second-step transaction without a vote by target shareholders. If a shareholder vote is required, locked-up shares may be counted toward the majority approval requirement (see part 5 "Second-step transactions").

An issue under Canadian law is whether a shareholder that enters into a lockup agreement will be treated as acting jointly or in concert with the offeror. If so, the bid may be treated as an insider bid requiring a formal valuation, and the shares may not be counted toward the majority approval of a second-step going-private transaction. However, the fact that the shareholder has entered into a lockup agreement with the offeror, even if the agreement is irrevocable and broadly worded, will not alone be sufficient to establish that the shareholder and offeror are acting jointly or in concert. Generally, for a "joint actor" relationship to exist, there must be other circumstances beyond the agreement, such as a prior or existing relationship between the shareholder and the offeror, some other involvement by the shareholder in the planning or negotiation of the transaction, or some collateral benefit accruing to the shareholder as a result of signing the lockup agreement.

Under U.S. rules, an acquiror must disclose its entry into a lockup agreement if the lockup results in the acquiror beneficially owning more than 5% of the target's securities. If the acquiror is offering share consideration, there is some risk that lockup agreements could trigger the SEC's gun-jumping rules, which prohibit offers of securities before a registration statement is filed. The SEC staff has provided guidance that in connection with a business combination transaction the entering into lockup agreements before the registration statement is filed is acceptable if, among other things, the lockups involve a limited group of parties (including executive officers, directors and holders of 5% or more of the target's securities) and all holders of target securities will be offered the same consideration.

As in the case of pre-bid purchases, acquirors in both jurisdictions must disclose the details of lockup agreements in the formal offering documentation that is filed with securities regulators and delivered to target shareholders, and those filings must include a copy of the agreement itself.

4

The rules of the road

Timeline

Please see Appendix A for a cross-border takeover bid/tender offer timeline.

Announcing a transaction

A friendly transaction will be announced when a merger or support agreement is signed, if it has not already been announced during the negotiating period. In the United States, any informal written materials (such as news releases, investor presentation materials or website postings) that the acquiror or target uses between the time the transaction is announced and its closing must be filed with the SEC on the same day they are used.

Commencing a transaction

In Canada, a bidder may commence a bid by publishing a summary advertisement or by mailing the bid circular to target shareholders. In the United States, a transaction must be formally commenced within a reasonable time of being announced. Commencement of a U.S. tender offer occurs with the publication of a summary advertisement. In both jurisdictions, the acquiror must notify the applicable stock exchange(s) and deliver the bid and the bid circular to the target. In Canada, the acquiror must file a takeover bid circular with securities regulators. The U.S. equivalent of a takeover bid circular is Schedule TO, which the acquiror files with the SEC and which contains an Offer to Purchase that is mailed to target shareholders.

Takeover bid circulars and Schedule TOs contain extensive disclosure about the transaction for the benefit of target shareholders. These disclosure requirements are summarized in part 7 "Documentation and regulatory review."

The target's response

In a friendly transaction, a target's response to a bid is typically mailed to its shareholders along with the acquiror's materials.

Under Canadian rules, a target's position regarding a takeover bid must be disclosed in a directors' circular, which must be filed no later than 15 days after commencement of the bid. In the director's circular, the directors must: (i) recommend that shareholders either accept or reject the bid and give reasons for the recommendation; or (ii) explain why no recommendation is being made. Alternatively, the directors may state that the bid is being considered and request that shareholders refrain from tendering their shares until the board is ready to make a recommendation, in which case the final deadline for the board's

recommendation is seven days before expiry of the bid. The director's circular must disclose any information that would reasonably be expected to affect the target shareholders' decision to accept or reject the bid, as well as certain other prescribed information.

The U.S. equivalent of a directors' circular is Schedule 14D-9, which must be filed with the SEC within 10 business days of commencement of the tender offer. Like the Canadian directors' circular, Schedule 14D-9 must disclose the target board's position regarding the transaction. Until the Schedule 14D-9 is filed with the SEC, the target is prohibited from communicating with its shareholders about the transaction, except to advise them to "stop, look and listen"—that is, to refrain from tendering their shares until the board finishes its review of the offer and discloses its position in the Schedule 14D-9. In the Schedule 14D-9, the board may recommend acceptance or rejection of the offer, or it may state that it has no opinion or is unable to take a position.

A cross-border bid that is subject to both the U.S. and Canadian rules will be commenced simultaneously in both jurisdictions. The operative deadline for the target's initial filing will be the shorter of the Canadian deadline of 15 calendar days or the U.S. deadline of 10 business days after commencement.

Deposit period for tendering to an offer

In Canada, bids must be open for securityholders to deposit their shares for a minimum of 105 calendar days after commencement. The bid may be extended, but if all conditions are satisfied or waived, the acquiror must first take up the tendered shares. All bids must have a mandatory minimum tender condition of over 50% of outstanding shares (aside from shares held by the bidder and its joint actors). The deposit period must be extended by 10 days once the 50% minimum tender threshold has been met and the bidder announces its intention to immediately take up the tendered shares.

A target board may shorten the 105-day deposit period to a minimum of 35 days by issuing a news release to that effect. The 105-day deposit period will also be shortened to at least 35 days if the target issues a news release announcing a friendly alternative transaction, such as a plan of arrangement. To take advantage of a shortened deposit period in these circumstances, the bidder must send a notice of variation (but its bid must not expire before 10 days from the date of the notice of variation). The shortened deposit period will apply to all competing bids.

In the United States, the minimum open period must be at least 20 business days. There is no mandatory minimum tender condition equivalent to Canada's 50% rule. A U.S. bid may be extended, but no shares may be taken up and withdrawal rights must be available throughout the extension period. Alternatively, an acquiror may take up shares and grant a subsequent offering period lasting at least three business days if all conditions to the offer are satisfied or waived and shares are taken up on a daily basis. The most likely reason for having a subsequent offering period would be that during the minimum offering period, the acquiror failed to acquire the minimum ownership level needed to effect a second-step transaction without a shareholder vote.

A cross border bid that is subject to both Canadian and U.S. rules will have to comply with the more stringent—meaning the longer—minimum open deposit period, i.e., the Canadian period of somewhere between 35 and 105 days.

Changes to bids

Under Canadian rules, a notice of variation or change must be filed with securities regulators if the terms of a bid are varied or a change has occurred that would reasonably be expected to affect a target shareholder's decision to accept or reject the bid. A bid must remain open for at least 10 days following any such change or variation (except in the case of all-cash bids if the variation is the waiver of a condition). The notice of variation or change must be sent to all holders except those whose securities have already been taken up. Except for increasing the consideration or extending the deposit period, a bidder is prohibited from varying the terms of its bid once the deposit period has expired and the bidder has become obligated to take up tendered shares.

Certain variations (such as lowering or changing the form of bid consideration, lowering the proportion of shares sought in a bid or adding new conditions) may be viewed by Canadian securities regulators as prejudicial to target shareholders. In such circumstances, the regulators may intervene to cease trade the bid, require an extension of longer than 10 days, or require the bidder to commence a new bid.

In the United States, an acquiror must promptly amend the Schedule TO filed with the SEC and notify target shareholders of any material change in the offer. Material changes originating with the target company must similarly be disclosed in an amended Schedule 14D-9.

The last day for increasing or decreasing the percentage of target securities sought in a U.S. tender offer or changing the consideration without extending the offering period is the 10th business day following commencement (the same day that the target's Schedule 14D-9 is due). The last day for other material changes (e.g., waiving a condition or eliminating a subsequent offering period) without having to extend the offering period is 15 business days following commencement.

Withdrawal rights

The Canadian rules permit shareholders to withdraw their tendered shares at any time before the shares are taken up or, if the shares have been taken up but not paid for, within three business days of being taken up. If the bid has been changed, tendered shares may be withdrawn at any time during the 10 days following notice of the change. These withdrawal rights are not applicable for increases in consideration or waivers of conditions in all-cash bids. Also, after the initial deposit period has expired, shareholders are not permitted to withdraw their tendered shares if there is an increase in the consideration offered or the deposit time is extended to a maximum of 10 days from the notice of variation.

The U.S. rules permit shareholders to withdraw their tendered shares at any time before the minimum offering period expires or during an extension of the bid (other than a subsequent offering period). Shareholders may also withdraw after the 60th day from commencement if the acquiror has not yet paid for the shares. Withdrawal rights need not be granted during subsequent offering periods.

Price

The general rule is that all target shareholders must be offered identical consideration in a takeover bid in Canada or a tender offer in the United States. In Canada, this makes it difficult—absent exemptive relief—

for bidders to extend offers to shareholders on just one side of the border to avoid regulation on the other side of the border. In U.S. terminology, these equal treatment rules are referred to as the “all-holders” and “best-price” rules. Furthermore, any price increases during the course of a Canadian bid or U.S. tender offer must be retroactive for the benefit of shareholders who had already tendered.

Purchases outside a bid

From the time that a takeover bid or tender offer is announced until it expires, the acquiror may not purchase or arrange to purchase target securities, publicly or privately, except under the terms of the formal offer—that is, in compliance with the best-price/all holders rules and other requirements. The Canadian rules (but not the U.S. rules) provide an exception for limited market purchases during a bid, but this is rarely relied on because doing so could negatively affect the acquiror’s ability to effect a second-step business combination (see part 5 “Second-step transactions”). Private agreement purchases are also prohibited under Canadian rules for 20 business days after a bid expires. The U.S. rules provide limited exemptions for purchases outside the tender offer depending on the level of U.S. ownership.

Collateral benefits

Some ancillary agreements or arrangements in connection with takeover bids and tender offers may raise the question of whether unequal consideration is being offered to different shareholders. Examples include commercial arrangements with a target’s customers or suppliers who are shareholders or employment arrangements with a target’s employees who are also shareholders.

In Canada, bidders sometimes seek exemptive relief to permit such collateral arrangements. Canadian regulators have, however, relaxed the prohibition in respect of employment compensation, severance or other employment benefit arrangements. These are not prohibited if: (i) the arrangement merely enhances group plan benefits for employees generally; or (ii) the arrangement is fully disclosed and relates to a shareholder who beneficially owns less than 1% of the target’s securities, is not conferred for the purpose of increasing the consideration paid under the bid or providing an incentive to tender and is not conditional on the shareholder’s supporting the bid in any way.

Alternatively, if the shareholder beneficially owns 1% or more of the target’s equity securities, employment-related benefits are not prohibited if an independent committee of the target’s board of directors determines that: (i) the shareholder is providing at least the equivalent value in exchange for the benefits; or (ii) the value of the benefits is less than 5% of the value that the shareholder would receive for tendering to the bid. The independent committee’s opinion, if any, would have to be disclosed in the takeover bid circular or directors’ circular.

In the United States, aggrieved shareholders of target companies have sometimes sued under the best-price rule, arguing that side payments by bidders under commercial or employment arrangements are really part of the tender offer consideration and should be paid to all shareholders. U.S. courts have taken inconsistent approaches to deciding whether such collateral arrangements fall within the ambit of the best-price rule. Historically, inconsistent jurisprudence combined with the severity of the remedy (increasing the consideration paid to all shareholders) has created a litigation risk associated with tender offers in the United States. To avoid this risk, companies sometimes avoided tender offers in favour of mergers as their

means of acquiring target companies. In response, the SEC amended the best-price rule in an attempt to remedy the disincentive to conduct tender offers. The changes clarified that the best-price rule does not apply to payments or offers to make payments that are made in connection with a tender offer but that are not part of the consideration for the securities tendered.

Like Canada's rules on collateral benefits, the SEC's best-price rule includes a specific exemption for employment compensation, severance and other employee benefit arrangements. To qualify for the exemption, a payment or an offer of payment must be made only for past or future services and must not be calculated on the basis of the number of securities tendered. Depending on the circumstances, arrangements will be presumed to satisfy those two criteria if they are approved by an independent compensation committee (or another independent committee) of the target's or bidder's board of directors.

Conditions

Takeover bids and tender offers are permitted to be conditional; however, financing conditions are not permitted in Canada. Acquirors bidding for Canadian targets must make adequate financing arrangements before making a bid. This does not mean that the financing must be unconditional. Rather, the bidder must reasonably believe that the possibility is remote that it will not be able to pay for the securities. Acquirors must further consider the possibility and costs of having to maintain financing over a minimum bid duration of 105 days.

In the United States, financing conditions are permitted but not common. Market practice is for bidders to secure financing commitments before launching a tender offer. In some cases the tender offer may be conditional on funding, i.e., the acquiror's receipt of the financing proceeds, and this may be accompanied by a reverse breakup fee in the merger agreement to compensate the target if the bidder is unable to complete the transaction due to the funds not being received.

More generally, the types of conditions that are acceptable in takeover bids and tender offers are a matter of market practice and judgment and should be discussed with advisers. [5] The nature and scope of conditions that parties can negotiate may also be affected by broader economic factors which can drive the M&A markets to be more buyer-friendly or more competitive and target-friendly.

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[5] CSA Staff Notice 62-305 *Varying the Terms of Take-Over Bids* set out Staff's view that takeover bid conditions must be *bona fide* and should be interpreted in good faith and on a reasonable basis. Where the failure of a condition is being relied on to vary a bid or where a condition is drafted in a way that the bidder has sole discretion or judgement as to whether the condition has been satisfied, Staff may intervene where necessary to ensure that judgement or discretion is exercised in a reasonable way. The SEC, in Question 101.01 of its Compliance and Disclosure Interpretations regarding "Tender Offer Rules and Schedules", states that a "tender offer may be subject to conditions only where the conditions are based upon objective criteria and otherwise not within the offeror's control. If an offeror could arbitrarily determine or control whether an offer condition has been triggered…, the offer would be illusory and may constitute a manipulative or deceptive act or practice…"

Shareholder approval

Takeover bids and tender offers involving all-cash consideration do not require approval by a bidder's shareholders. However, if the consideration includes the bidder's securities and the bidder is listed:

- On the TSX, approval by the bidder's shareholders will be required if the number of securities to be issued exceeds 25% of the bidder's outstanding securities or if the transaction will materially affect control of the bidder (for example, the creation of a new 20% shareholder of the bidder).[6]
- On a U.S. stock exchange, approval by a bidder's shareholders will generally be required if the number of securities to be issued is equal to or exceeds 20% of those outstanding or the transaction would result in a change of control of the issuer.

If a bidder is listed in both Canada and the United States, one exchange may defer to the shareholder approval requirements of the other, depending on which is the issuer's home jurisdiction and, in the case of the TSX, if less than 25% of the overall trading volume takes place on all Canadian marketplaces in the preceding 12 months.

Following a bid, approval by the target's shareholders may or may not be required to enable the acquiror to purchase the untendered shares and acquire full ownership of the target (see part 5 "Second-step transactions").

[6] TSX guidance enables a bidder using listed stock as consideration to "top up" the number of shares to be issued in a bid by up to 25% of the number approved by shareholders without obtaining further shareholder approval, subject to certain disclosure requirements, providing flexibility for a bidder to quickly increase the consideration offered in a contested situation.

5

Second-step transactions

A bidder is highly unlikely to acquire all of a target's shares in a takeover bid or tender offer and, therefore, some form of second-step transaction will be necessary to obtain 100% ownership. The form of second-step transaction and its speed will depend primarily on the percentage of target shares that the acquiror owns after the bid. The mechanics of second-step transactions are governed by the corporate laws under which the acquiror and target are incorporated or organized. To simplify the mechanics of the transaction, acquirors commonly incorporate a new subsidiary as an acquisition vehicle in the same jurisdiction where the target is incorporated or organized.

Second steps in Canada

When a bidder obtains at least 90% of the outstanding shares of a Canadian target company under a bid, Canadian corporate law statutes generally confer a compulsory acquisition right in favour of the bidder to acquire the balance of the securities, provided such 90% threshold is reached no later than 120 days after the date the bid was commenced. In calculating the 90% threshold, securities held by the bidder at the time of making the bid or acquired in the open market during the bid must be excluded. No shareholder approval is required for a compulsory acquisition and, as a result, it can be completed quickly and efficiently.

If the statutory compulsory acquisition procedure referred to above is not available (i.e., because the bidder failed to achieve a 90% tender to the bid), the bidder may instead be able to effect a transaction that squeezes out the remaining minority shareholders (at the same price as was offered under the bid), as long as the bidder: (i) owns at least ⅔ of the outstanding shares after the bid; (ii) acquired, through the formal bid, a majority of the shares that it did not own beforehand; and (iii) satisfies the additional requirements of the business combination rules under Multilateral Instrument 61-101. MI 61-101 requires, among other things, that the bidder make clear in its takeover bid circular that it intends to undertake this type of transaction after the bid—and it must do so within 120 days of the expiry of the bid.

The minimum tender condition for a takeover bid usually reflects the ⅔ supermajority voting requirement, which applies to amalgamations under the *Canada Business Corporations Act and* Ontario's *Business Corporations Act*. The bidder is then assured of being able to complete the second-step transaction because it will control a sufficient number of votes to approve it. To meet the ⅔ voting requirement, the bidder is entitled to vote the shares tendered to the formal bid.

The business combination rules are viewed as containing a complete code for these types of transactions and, accordingly, squeeze-out transactions completed under these rules are not typically susceptible to challenge by minority shareholders.

Second steps in the United States

An acquiror bidding for a U.S. company may count all of its target shares, including those purchased before the tender offer, for purposes of calculating whether it has reached the minimum ownership level needed to effect a short-form merger. A short-form merger, like a compulsory acquisition in Canada, does not require a shareholder vote and can be consummated very quickly after the tender offer is completed. The required minimum ownership level is 90% of the target's shares in most U.S. states, but the rule in Delaware—the most popular place of incorporation for U.S. public companies—is significantly more favourable. Specifically, for Delaware targets, a second-step merger may be effected without a shareholder vote to approve the transaction, as long as the acquiror owns a majority of the target's shares following the tender offer and certain other requirements are met. This means that an acquiror can obtain 100% ownership of a Delaware target very quickly following a tender offer. In other U.S. states, if an acquiror owns less than 90% of the target's shares following a tender offer, target shareholders will be entitled to vote on a long-form merger at a shareholders' meeting. Approval by a majority of the target's shares is required (as opposed to Canada's requirement for approval by ⅔ of the votes cast at the meeting). Since the acquiror will be permitted to vote all of its shares acquired in the first-step tender offer, it should have sufficient voting power to ensure approval.

Dissent and appraisal rights

Target shareholders who object to a second-step transaction are, under the corporate laws of most jurisdictions, entitled to appraisal rights—that is, they are entitled to apply to a court for an appraisal of the value of their shares (which could be higher or lower than the tender offer price, but is likely to be equal to the tender offer price if the transaction was arm's length)[7]. The appraised value will be paid by the surviving company to objecting shareholders who satisfy all relevant corporate law requirements. Appraisal rights are available for all second-step transactions by Canadian companies. In the United States, most states provide appraisal rights unless the surviving company is listed on a stock exchange and the tender offer consideration consists solely of stock (other than cash in lieu of fractional shares).

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[7] The Ontario Court in *1843208 Ontario Inc. v Baffinland Iron Mines Corporation* confirmed that, in the context of fixing fair value in a dissent and appraisal proceeding for an M&A transaction, Canadian courts will typically prefer market evidence over theoretical valuations of publicly-traded entities. Courts will give substantial weight to the deal price, if generated through a robust bid process, in determining fair value.

6

The target's board of directors

Overview of fiduciary duties

The target board's role is particularly prominent in change of control transactions 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 include:

- Providing adequate information to shareholders to allow them to make a fully informed decision about a takeover bid or an acquisition proposal.
- Making a meaningful recommendation to shareholders to accept or reject a bid or acquisition proposal or provide reasons why they are not doing so.
- Considering whether to solicit or receive potentially superior alternatives and whether any proposed support or merger 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.[8]

[8] 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 and insider bids.

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 bid.[9]
- 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

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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.*

[9] Decisions of the Ontario Securities Commission 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.

the interests of creditors and employees. In such circumstances, while respecting legal rights and 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. Under Delaware corporate law, however, a director's fiduciary duties generally are solely to the corporation and its stockholders.

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.

The 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. Rather, the corporation's interests must be assessed by reference to the interests of all affected stakeholders, including creditors and employees. 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.

Canada's securities regulators have taken the position in National Policy 62-202 that the primary objective of takeover bid laws is to protect the bona fide interests of the target's shareholders. Consistent with this, the board's duty under corporate law to act in the best interests of the *corporation* was historically interpreted to mean acting in a manner that maximizes shareholder value. In other words, the interests of the corporation have been equated with the interests of shareholders. But 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.[10]

In the United States, if the transaction involves a controlling shareholder or the actions of a target's board suggest that the directors failed to exercise reasonable business judgment, the courts may impose a heightened standard of review on the board by looking at the "entire fairness" of the transaction to target shareholders, which generally requires that the transaction be fair as to price and process to unaffiliated shareholders.

Once a U.S. target is "up for sale," the target's board is obliged to seek the best price reasonably available for shareholders. This is known as the "Revlon" duty, and it applies to corporate control situations unless

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

the target's stock is widely held before the transaction and will remain widely held after the transaction. Under the Revlon test, a sale of a target is considered inevitable, and the duty to seek the best price is triggered, if the target:

- Initiates a bidding process.
- Seeks an alternative to an unsolicited transaction that also involves a breakup or change of control.
- Otherwise abandons its long-term strategy through a change of control.

Canadian companies are sometimes referred to as being "always for sale." This means that the fiduciary duties of a Canadian board do not depend on whether a change of control is inevitable. But despite the different nuances of Canadian and U.S. laws, the factors that boards in both countries should consider and the processes that they should use in evaluating the merits of competing transactions or responding to an unsolicited offer are very similar.

A target's board in Canada or the United States 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 extremely valuable, but a market check may sometimes be achieved in ways other than via a public auction.

Defensive measures

One of the most difficult problems faced by the directors of a target corporation in managing a takeover bid process is the extent to which they may take measures to defend against a hostile bid that they believe is not in the best interests of the corporation. Boards of directors often take defensive measures against bids that they believe are not in their company's best interests or do not reflect the true value of the company's shares.

Canadian securities law, in contrast to corporate law, continues to adhere to the shareholder primacy paradigm in its regulation of change of control transactions. Canadian securities regulators will not permit target directors, using defensive tactics, to frustrate shareholder access to an offer, even if the directors have reached a well-founded conclusion that the offer is not in the best interests of the target, having regard to all affected stakeholders. In these circumstances, Canadian securities regulators, using their public interest jurisdiction, may make orders against the target neutralizing the defensive measure. Defensive measures have historically been more aggressive in the United States than in Canada, although one general principle is theoretically the same in both jurisdictions: target shareholders should not be coerced.

The influence of institutional shareholders over corporate control transactions is significant in both Canada and the United States. Although a Canadian target's available legal defences are thought to be somewhat weaker than a U.S. target's, the board may mount a defence against a hostile bid by lobbying the company's

institutional shareholders to persuade them that the bid should be rejected. In the United States, institutional shareholders have pressured some companies to abandon their poison pills, thus eroding the board's power to "just say no" even when it might be legal to do so. Under Delaware law, defensive measures taken by a target's board of directors at the time of a bid will face enhanced scrutiny to ensure that the directors exercised their business judgment properly. The enhanced scrutiny standard was established in *Unocal Corp. v. Mesa Petroleum Co*. in 1985. Under the Unocal test, for a defensive measure to be valid, the board must have reasonable grounds for believing that the bid amounts to a threat to corporate policy and effectiveness, and the defensive measures must be proportionate to the threat and not preclusive or coercive.

Poison pills

Shareholder rights plans, or "poison pills," consist of certain rights granted to existing shareholders (either in the face of an unsolicited bid or as part of a target's takeover-preparedness program). These rights allow existing shareholders to either purchase target shares at a substantial discount or require the company to buy them back at a substantial premium, in each case rendering an unsolicited bid uneconomic because of massive dilution of the bidder's position.

Tactical poison pills, designed to expand shareholder choice, were historically tolerated by securities regulators for a time-limited period in view of the short minimum period bidders had to leave their offers open for. In 2016, the Canadian takeover bid rules were amended and now require that a takeover bid be open for at least 105 days, which eliminates the rationale for poison pills as a defensive measure. Absent unusual circumstances, securities regulators are now very unlikely to allow a target board to use a poison pill merely to extend the timing of a hostile bid. Target boards may nevertheless see the benefit of adopting a poison pill in order to regulate exempt purchases of target securities through creeping acquisitions and private agreement purchases and prevent irrevocable lockup agreements.

In the United States, a target's board may be able to "just say no" and keep its pill in place for a longer period of time than has traditionally been allowed in Canada. But even in the United States, a poison pill is not necessarily a "showstopper" because a court may not permit it to indefinitely block a fully financed, fair offer, and shareholders may also exert pressure on a company to remove the pill. Like all defensive measures put in place in response to a bid, poison pills are subject to enhanced scrutiny under the U.S. Unocal test.

State anti-takeover statutes

Some U.S. states have anti-takeover laws that prohibit second-step mergers for three to five years unless they have board or shareholder approval, restrict control block acquisitions or impose substantive fair price standards on acquisitions that the target's board has not approved in advance. These statutory defences are not found in corporate statutes in Canada.

Legal challenges

A Canadian or U.S. target may attempt to delay or avoid a takeover by bringing a lawsuit against the acquiror on various grounds. A target may seek a preliminary injunction on the basis that a transaction

would violate antitrust laws. Other common defensive actions that targets take include challenging the acquiror's disclosure in its regulatory filings or challenging the legality of the acquiror's pre bid purchases.

Alternative transactions

A target's board may consider entering into a transaction to help defend itself against a hostile takeover. Some transactions that are more common in the United States are regarded as questionable tactics in Canada under National Policy 62-202 Take-Over Bids – Defensive Tactics if they are used solely to frustrate a takeover bid or impede an auction. These include selling or optioning assets, issuing employee stock options, granting "golden parachutes" to executive officers, selling stock or options to a friendly third party or entering into other material transactions outside the ordinary course of business.

Defensive transactions that are permissible in both Canada and the United States (as long as they are consistent with the target board's fiduciary duties) include making an issuer bid, granting a special dividend to shareholders or otherwise recapitalizing the company.

Target boards have also turned to private placements as a defensive measure, issuing shares to friendly investors unlikely to tender to the hostile bid. Securities regulators have adopted an approach to this defensive measure that considers whether the private placement has a bona fide corporate purpose along with the impact of the share issuance on the takeover bid dynamic and the target shareholders' ability to respond to the bid.

Defensive charter or by-law provisions

Defensive measures that are built into a target company's charter or by-laws are usually invalid under Canadian law but are common in the United States. One exception is the use of dual class share capitalization structures which are permitted in both jurisdictions although corporate governance commentators are critical of them.

Defensive provisions that may be part of a U.S. target's organizational documents include the following:

- Implementing staggered boards that prevent shareholders from replacing directors "without cause" or replacing the whole board at once.
- Imposing supermajority voting or fair price requirements for business combinations.
- Prohibiting or restricting the power of shareholders to call a meeting.
- Issuing blank cheque preferred stock that can be used for a poison pill or issued to a "white knight" (a friendly acquiror) or a "white squire" (a friendly purchaser of the target's assets).
- Opting in to certain state statutory provisions that impose restrictions or penalties on persons that acquire more than a specified percentage of common stock.
- Limiting shareholders' ability to remove directors without cause or to act by written consent instead of by voting at a shareholders' meeting.
- Granting power to the board to set its own size and fill any vacancies.

- Prohibiting cumulative voting for the election of directors.

Deal protections

The parties to a friendly bid 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 merger or support agreement (see part 7 "Documentation and regulatory review"). Deal-protection measures are subject to the target board's fiduciary duties discussed above—that is, those duties cannot be emasculated by contractual deal protections.

In a negotiated acquisition, 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 acquisition agreement in a negotiated acquisition.

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, also 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 an 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 bidder. 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. This sort of deal protection is uncommon in the United States and has been scrutinized by the courts. 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 and regulatory review

Canadian and U.S. securities laws require the parties to provide very similar disclosure in their regulatory filings for the benefit of target shareholders. Generally speaking, takeover bid circulars - and the U.S. equivalent, the Schedule TO—must include comprehensive information about the transaction and the negotiations leading up to it, the bidder's plans regarding the target and any material non-public information that the bidder has learned in the course of investigating the target.[11] In addition, prospectus-level disclosure about the acquiror will be required if the consideration includes securities.[12]

Canadian regulators are unlikely to review the filings. In the United States, unless a tender offer exemption is available, the SEC may review the parties' filings, including the financial information; ask questions and seek clarification about the disclosure; and require additional filings or mailings to target shareholders. This regulatory review could delay the planned expiration date of a tender offer or otherwise lengthen the timetable for completing a transaction.

In both jurisdictions, the bidder and target are potentially liable to private plaintiffs for any material misstatements or omissions in the disclosure.

Acquiror's offer to purchase

An acquiror's takeover bid circular or Schedule TO must cover the following topics:

- Background of the offer, which includes material contracts, arrangements, understandings, relationships, negotiations or transactions between the bidder and the target during the past two years (this disclosure is required in Canada only if the information is currently material).
- Any material non-public information that the bidder has learned about the target, such as projections or other information acquired during due diligence.
- The bidder's plans for material changes to the target, such as extraordinary transactions or delisting from a stock exchange.

[11] Additional disclosure requirements apply to going-private transactions (see "Going-private transactions" in part 2 "The lay of the land").

[12] If the acquiror is not already a reporting issuer, offering securities as consideration could also give rise to new ongoing reporting obligations.

- Any agreements or arrangements between the acquiror and any of the target's officers or directors.
- Any transactions in the target's securities by the acquiror, its officers and directors, and various other parties connected to the acquiror, depending on the circumstances; this disclosure must cover trading during the past six months[13] under Canadian rules and during the past 60 days under U.S. rules.
- Details regarding the financing arrangements—that is, the terms of any agreements, including conditions of financing and alternative arrangements if financing falls through.

Canadian rules require that agreements between the offeror and the target, between the offeror and a target securityholder, or between the offeror and an officer or a director of the target be filed, as well as any other material documents that could affect control of the target, such as a voting trust agreement. Any agreements or contracts referenced in a U.S. offer to purchase, such as financing commitments, must be filed with the SEC as exhibits.

Financial statements

Under Canadian and U.S. requirements, the acquiror's historical financial statements must be filed and included or incorporated by reference in the bid materials provided to target shareholders if the consideration includes securities of the acquiror. In the United States, the bidder's financial statements may be required even in an all-cash transaction if the bidder's financial condition is material to target shareholders, which may be the case if the tender offer includes a condition related to financing or if the bidder is not an SEC-reporting issuer. Pro forma financial statements will have to be prepared to show the effect of an exchange of securities if the transaction is significant to the acquiror and is not an all-cash deal. As an exception in the United States (but not in Canada), pro forma financial statements are not required in unsolicited transactions.

The target directors' response

A target company's directors must disclose their position on an offer in a directors' circular in Canada or a Schedule 14D-9 in the United States. Like the bidder's disclosure, this disclosure must be truthful and not misleading and must include, in addition to the directors' recommendation to accept or reject the deal, all pertinent information that could affect a target shareholder's decision to tender, including the following:

- Information about trading in the target's securities during the six months (12 months in the case of an insider bid) preceding the bid (in Canada) or during the 60 days preceding the bid (in the United States) by the target, its directors and officers, and various other parties connected to the target, depending on the circumstances.
- A description of any arrangements, board resolutions, negotiations, agreements or other material actions taken in response to the bid—that is, dividends, asset sales or other extraordinary transactions that could be characterized as defensive in nature (these may be kept confidential under U.S. rules if the negotiations are preliminary and disclosure would jeopardize them).

[13] Twelve months in the case of a takeover bid made by an insider.

- Full disclosure about any fairness opinion delivered to the target's board.

The merger agreement

Key provisions of the merger agreement entered into by the parties to a friendly deal typically include the following:

- Deal-protection measures such as:
  - a breakup 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 competing transaction or upon a competing transaction being completed;[14] 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 nature and quality of the target's business.
- Certain representations regarding the acquiror's business (if shares are offered as consideration or, in the United States, if there is a condition related to financing).
- Permission for continued access by the acquiror to confidential information about the target.
- A minimum tender condition that cannot be waived without the target's agreement, to ensure that the minority shareholders can be "squeezed out" in a second-step transaction.
- A "material adverse effect" clause, which permits the acquiror to abandon the transaction upon certain negative changes in the target's business pending closing.
- 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 bidder's financing arrangements.
  - not to take extraordinary actions or incur certain expenditures without consulting with or obtaining the consent of the acquiror.

[14] The acquiror may pay a reverse breakup 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).

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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. U.S. antitrust laws, including the *Clayton Act* and the *Hart-Scott-Rodino Antitrust Improvements Act of 1976* (HSR Act), apply to U.S. businesses as well as Canadian and foreign companies with sufficient sales into the U.S. 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*. In the U.S., the Federal Trade Commission (FTC) and Antitrust Division of the U.S. Department of Justice (DOJ) share responsibility for enforcing the antitrust laws and implementing regulations.

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:[15]

- **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 or from Canada that exceed C$93 million.[16]
- **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.

[15] 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.

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

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.[17]

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 significant competition law issues.

HSR in the U.S.

The Canadian pre-merger notification regime is similar to the U.S. regime established by the HSR Act.

For acquisitions exceeding specified thresholds of transaction and party size, the HSR Act requires that pre-transaction notice must be given to the FTC and DOJ, and that a waiting period of 30 days (15 days in the case of a cash tender offer) be observed before securities can be acquired or the transaction completed. As in Canada, this period is extended if a request for additional information (referred to as a "second request") is issued.

The current[18] U.S. transaction-size threshold is US$119.5 million, measured as the value of the voting securities that will be held as a result of the transactions, including securities already held by the buyer. A transaction exceeding that threshold may require notification if one party's net sales or total assets exceed US$23.9 million and the other party's net sales or total assets exceed US$239 million. If the size of the transaction exceeds US$478 million, notification is required regardless of the size of the parties' assets or sales unless a specific exemption applies. For minority shareholders, certain other notification thresholds permit additional share purchases after receiving HSR clearance without having to file a new pre-transaction notice.

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[17] 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 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.

[18] HSR thresholds are adjusted annually before the end of the first quarter.

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$1.326 billion[19] unless: (i) the acquisition involves a Canadian "cultural" business in which case the book value of assets of the Canadian business must exceed C$5 million (in the case of a direct acquisition) or C$50 million (in the case of an indirect acquisition); or (ii) the investor is a state owned enterprise (SOE), in which case the book value of the assets of the Canadian business must exceed C$528 million.

Investments will be approved if they meet a "net benefit to Canada" test; however, investments in certain culturally sensitive areas, such as book publishing and film/ video distribution, are subject to a greater level of scrutiny.

The review period usually lasts for at least 75 days after a complete application is submitted.

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.

Additionally, the government may review virtually any foreign investment transaction if there are reasonable grounds to believe the transaction "could be injurious to national security." The *Investment Canada Act* does not define "national security", and there is no financial threshold for review. 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 (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).

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.

In the United States, the mechanism for reviewing and potentially blocking foreign acquisitions that affect national security is the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which amended section 721 of the U.S. Defense Production Act of 1950, and which charges the President, acting

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

through the Committee on Foreign Investment in the United States (CFIUS), with reviewing acquisitions of, and investments in, U.S. businesses and real estate by foreign persons when U.S. national security is implicated. The President is authorized to prohibit transactions (or to order a divestiture in the case of a completed transaction) that threaten to impair the national security of the U.S. if that threat cannot be mitigated through an agreement negotiated with CFIUS.

CFIUS's review of a transaction can be commenced by parties to a transaction making a voluntary filing, or by CFIUS either before or after the transaction is completed. A pre-consummation submission to CFIUS is mandatory for transactions involving certain critical technologies or certain foreign government ownership. Because Canada is an "excepted foreign country," however, some Canadian investors may be exempt from making a filing to CFIUS. After accepting the filing of a notice, CFIUS conducts a 45-day review to determine whether a second stage, 45-day investigation is warranted. A foreign government–controlled acquisition establishes a presumption that the second-stage, 45-day investigation will take place (resulting in a 90-day review period). Parties may also file a shorter-form declaration that triggers a 30-day review period, although CFIUS can request the submission of a notice at the end of that period. FIRRMA defines the scope of national security beyond national defense to include the potentially broad concepts of homeland security, critical infrastructure, critical technologies and sensitive personal data..

CFIUS assesses national security implications on a case-by-case basis. Particular care is warranted in the case of foreign acquirors from countries where there are political sensitivities, e.g., China, Russia. The challenges and uncertainties, including the potential politicization of the CFIUS review process, have presented challenges to some transactions.

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 takeover bids and tender offers and should be incorporated into the transaction planning at an early stage.

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Avoiding dual regulation: cross-border exemptions

Canadian and U.S. regulators have established cross-border exemptions from regulation so that many takeovers will be eligible to proceed primarily under the rules of the target company's jurisdiction. An available exemption will allow parties generally to avoid duplicative compliance, including with two sets of procedural rules, two sets of disclosure criteria for filed documents-and the regulators in the jurisdiction where the deal is exempt will probably not review the documentation or impose timing requirements.[20]

Even if a cross-border exemption is available, certain rules pertaining to the fairness of the transaction will always apply. For example, bids must be open to all shareholders in both jurisdictions, deal documents must be sent to all shareholders, and all shareholders must be treated substantially equally (although not necessarily offered exactly the same form of consideration). In addition, parties are liable in both jurisdictions for misleading disclosure, insider trading or other fraudulent activities in connection with the transaction.

The multijurisdictional disclosure system

Canadian securities regulators and the SEC established the Multijurisdictional Disclosure System (MJDS) in 1991 to provide relief from dual regulation for certain Canada-U.S. transactions. The MJDS is based on the premise that the underlying principles and scope of regulation in Canada and the United States are very similar. Under the MJDS, the parties to a transaction need to comply with the laws of only one jurisdiction. The criteria for securing MJDS exemptions are extremely favourable to cross-border Canadian and U.S. companies.

U.S. tender offer rules for Canadian targets under the MJDS

If a Canadian or U.S. company seeks to acquire a Canadian target, the Canadian takeover bid rules will apply and the transaction will be exempt from most of the U.S. tender offer rules as long as:

- Less than 40% of the target's securities are beneficially owned by U.S. residents.

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[20] Although the SEC does not generally review the filed documents relating to Canadian bids that are exempt from the U.S. tender offer rules, it may do so if the offer is unsolicited.

- The target qualifies as a Canadian "foreign private issuer" as defined under SEC rules, which will usually be the case if a majority of its securities are owned by Canadians.[21]

If the consideration includes securities of the acquiror, the U.S. registration and disclosure requirements can be met by filing the Canadian circular with the SEC as long as the acquiror is a Canadian company that qualifies as a foreign private issuer and meets certain Canadian listing/reporting standards and public float requirements.

Canadian takeover bid rules for U.S. targets under the MJDS

The situation under the MJDS is reversed when a Canadian or U.S. bidder seeks to acquire the shares of a U.S. target company. In that case, the U.S. tender offer rules will apply (as well as the U.S. registration and disclosure requirements, if the consideration includes securities), but there will be an exemption from the Canadian takeover bid rules if, among other things, less than 40% of the target company's shares are owned by Canadian residents. (The transaction may still be subject to Canadian regulation at the second step if insufficient securities were acquired in the bid to complete a compulsory acquisition—see part 5 "Second-step transactions"). For U.S. acquirors, there will also be an exemption from the Canadian rules which require prospectus-level disclosure if securities are offered as consideration, as long as the acquiror, among other things:

- Has a 36-month SEC reporting history and 12-month NYSE, AMEX or NNM listing history.
- Has a public float of equity securities of at least US$75 million or is offering non-convertible, investment-grade debt or preferred securities.
- The U.S. prospectus is included in or incorporated by reference in the bid circular.

Exemptions based on *de minimus* shareholders in a jurisdiction

A non-MJDS exemption from the takeover bid rules may be available if the percentage of target shares and number of shareholders in a jurisdiction is extremely small. In Ontario, there is a *de minimus* exemption from the takeover bid regime if fewer than 50 target shareholders holding less than 2% of the target shares reside in Ontario and they are entitled to participate in the bid on terms as favourable as those for other shareholders. There is also an exemption from the takeover bid rules for transactions involving non-Canadian targets with Canadian shareholdings of less than 10% of the outstanding securities if certain other conditions are met (including that Canadian shareholders are entitled to participate in the bid on terms as favourable as those for other shareholders).

Similarly, an exemption is available from the U.S. tender offer rules if the target is a foreign private issuer with U.S. shareholdings of 10% or less. This is referred to as the "Tier I" exemption. The advantages of Tier I over MJDS are that (i) there is less risk of regulatory liability under Tier I because the offer documents

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[21] If more than 50% of a Canadian target's securities are owned by U.S. residents, the target may still qualify as a foreign private issuer, provided that a majority of its executive officers or directors are not U.S. citizens or residents; a majority of its assets are not located in the United States; and its business is not administered principally in the United States.

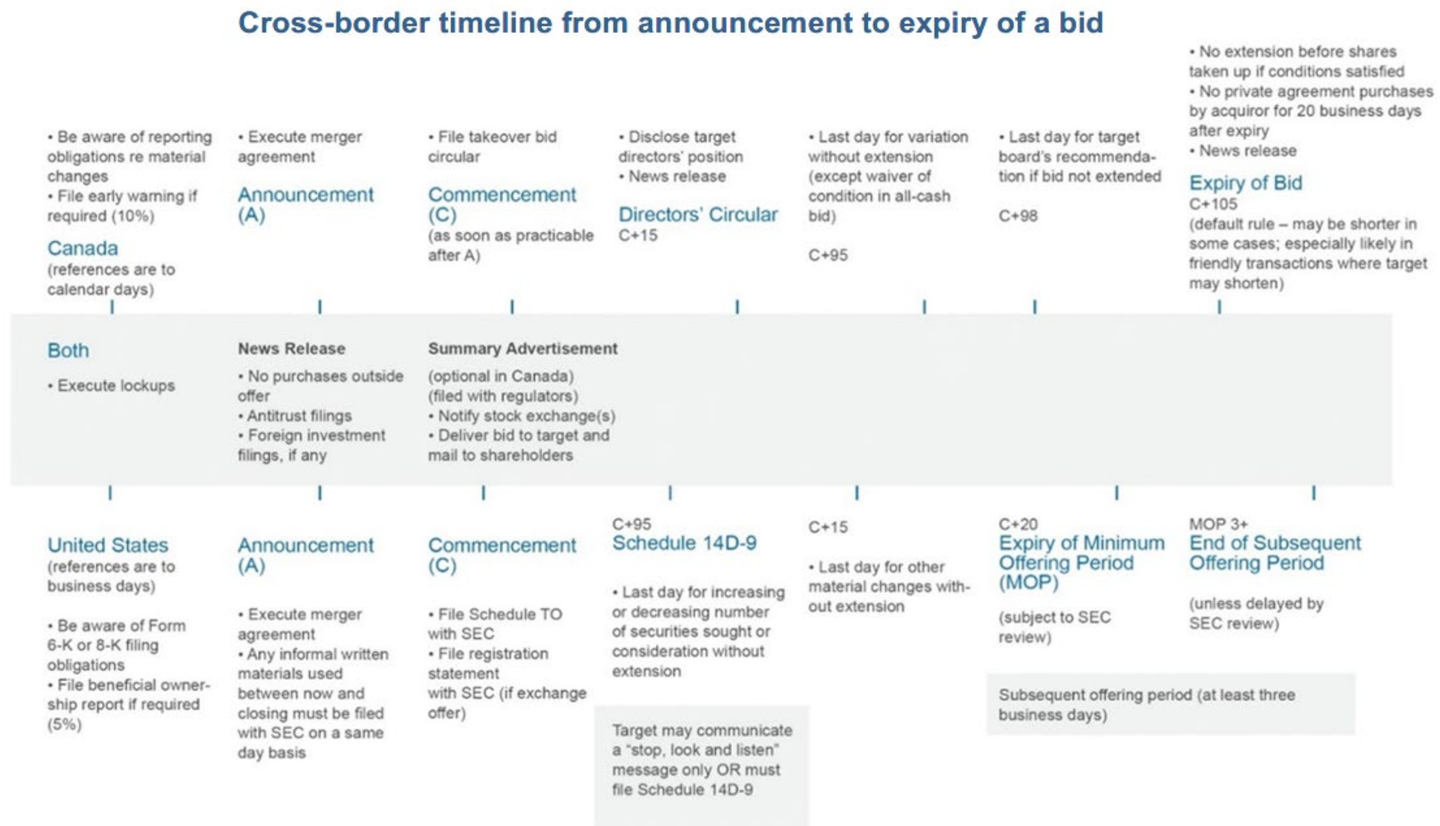
are not formally filed with the SEC (although they must be delivered to target shareholders); and (ii) purchases by the bidder and others during the offer period are not restricted under the Tier I exemption, as they are under MJDS.

A very limited Tier II exemption is also available for targets with U.S. shareholdings between 10% and 40%, but this exemption is much less favourable than the MJDS exemption and, therefore, it is less likely to be relied on in the context of a bid for a Canadian target.

10

Appendices

Appendix A - Cross-border takeover bid/tender offer timeline[22]



22 Assumes MJDS is not available. Given certain differences between U.S. and Canadian bid rules, compliance (or appropriate exemptions) with both regimes will be required.

About Torys LLP

Torys LLP is an international business law firm with offices in Toronto, New York, Calgary, Montréal and Halifax. Torys is known for its client-focused legal excellence, providing services in a range of areas, including mergers and acquisitions; corporate governance; capital markets; proxy contests and other contests for corporate control; litigation and dispute resolution; restructuring and insolvency; taxation; competition and anti-trust; environmental, health and safety; debt finance and lending; project development and finance; private equity and venture capital; managed assets; financial institutions; pension and employment; intellectual property; technology, media and telecom; life sciences; real estate; infrastructure and energy; climate change and emissions trading; and personal client services.

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