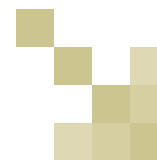


Canada

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MARKET AND INCENTIVES

1. Please describe briefly the private equity market in your jurisdiction, in particular:

- The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.
- Market trends (for example, the role of hedge funds in private equity).

Sources of funding

The main sources of funding in 2007 for private equity funds in Canada were as follows:

- Banks and other corporations (38% of funding to buyout and mezzanine funds and 8% of funding to venture capital funds).
- Pension funds (37% of funding to buyout and mezzanine funds and 12% of funding to venture capital funds).
- Individuals (5% of funding to buyout and mezzanine funds and 65% of funding to venture capital funds).
- Foreign sources (13% of funding to buyout and mezzanine funds and 12% of funding to venture capital funds).

Other fundraising sources for private equity include government and insurance companies (*source: Thomson Reuters*).

Market trends

The ongoing credit crisis and the subsequent uncertainty in global financial markets have had a negative effect on the ability of buyout funds to complete leveraged transactions. This has resulted in a sharp reduction in transactions and in falling deal sizes. The denominator effect (the overweighting of private equity holdings among institutions resulting from significant losses in public equity holdings) has handicapped fundraising efforts by private equity funds. This has resulted in a buyer's market which favours funds which completed their fundraising in 2007 or early 2008.

Another significant trend in the Canadian private equity market has been the increasing participation in recent years of institutional investors directly in syndicates pursuing buyout transactions. Historically, such participation has been primarily through co-investment with a fund in which the institutional investor has a pre-existing

investment. More recently, institutional investors have taken active roles in forming syndicates and leading transactions. The most noteworthy example of this trend was the 2007 bid led by Ontario Teachers' Pension Plan to acquire Canadian telecom leader BCE. Announced at Can\$52 billion (about US\$41 billion), this was to be the largest private equity buyout in history, although the transaction subsequently failed and is now in litigation.

Another prevailing trend has been the declining ability of venture capital funds to raise funds in the local market over the last five years. Total amounts raised fell from approximately Can\$2 billion (about US\$1.6 billion) in 2003 to approximately Can\$1.2 billion (about US\$0.9 billion) in 2007. This trend has been particularly noticeable in the retail fund sector (primarily labour-sponsored venture capital (*see Question 3*)) and has led to reduced investments by Canadian venture capital funds. This reduction in available venture capital funding has been partially compensated for by an increasing share of investments by foreign (primarily American) venture capital funds. Foreign funds are typically focused on investments in companies which are at a later stage of growth, and accordingly investments by venture capital funds in very early stage companies have become quite scarce.

2. Please summarise the level of activity in recent years in relation to:

- Fundraising by private equity funds and hedge funds.
- Private equity investment in established, early stage and start-up businesses.
- Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs) and public to private transactions).
- Exits from private equity funds (that is, the realisations of the investments).

Fundraising

Private equity funds in 2007 raised a total of approximately Can\$3.2 billion (about US\$2.6 billion), of which:

- Can\$1.7 billion (about US\$1.3 billion) was raised by buyout funds.
- Can\$1.2 billion (about US\$1 billion) was raised by venture capital funds.
- Can\$308 million (about US\$242 million) was raised by mezzanine funds.

These numbers represent a drop of 68% from the record Can\$10.2 billion (about US\$8 billion) raised by all private equity funds in 2006 and a drop of 17% from the Can\$3.9 billion (about US\$3.1 billion) raised by all funds in 2005. For the first three quarters of 2008, Canadian buyout funds raised a total of Can\$894 million (about US\$702 million) and venture capital funds raised a total of Can\$886 million (about US\$696 million). Quarterly numbers for mezzanine funds were not available at the time of writing (*source: Thomson Financial*).

Investment

There were a total of 543 venture capital investments in Canadian companies reported in 2007, with a total investment value of approximately Can\$2.1 billion (about US\$1.6 billion). 2006 saw a total of 549 venture capital investments with a total reported investment value of approximately Can\$1.7 billion (US\$1.3 billion). Of the 2007 total:

- Can\$60 million (about US\$47 million) was invested in companies as seed capital.
- Can\$632 million (about US\$497 million) was invested in other early stage companies.
- Can\$1.4 billion (about US\$1.1 billion) was invested in later stage companies.

2008 has seen a considerable reduction in the number and total value of investments in Canadian companies by venture capital funds, with a total of Can\$1 billion (about US\$0.8 billion) being invested in 296 companies in the first three quarters of the year. Average deal size has also dropped, from Can\$4.6 million (about US\$3.6 million) in 2007 to Can\$3.5 million (about US\$2.8 million) across the first three quarters of 2008.

Transactions

2007 was a record year for private equity buyout transactions in Canada. 2007 saw many large- and mid-market transactions, with a total of 179 other transactions, 68 of which disclosed transaction values totalling Can\$18.7 billion (about US\$14.7 billion), not including the Can\$52 billion BCE transaction. These figures represent a substantial increase over 2006, which itself was a record year with 105 transactions, 40 of which disclosed transaction values totalling Can\$8.2 billion (about US\$6.4 billion). Although the number and value of transactions in the second half of 2007 dropped considerably (mainly due to the international credit crisis), the market in 2008 remained steady through the first three quarters, with 29 transactions disclosing transaction values of Can\$6.4 billion (about US\$5 billion).

Exits

2007 saw a total of 49 venture capital-backed exits, of which 12 were through initial public offering (IPO) and 37 were by merger or acquisition. This was an increase over 2006, which saw a total of seven venture capital-backed IPOs and 31 venture capital-backed M&A exits. Average exit transaction value also increased from Can\$20 million (about US\$15.7 million) for IPOs to Can\$61 million (about US\$47.9 million), and from Can\$78 million (about US\$61.3 million) for M&A exits to Can\$104 million (about US\$81.7 million).

Data on exits by private equity funds in other segments is not readily available.

3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

Canadian-controlled private corporations (CCPCs) are entitled to a number of tax-related benefits (most of which are aimed at small businesses), including:

- A lower rate of tax deduction on operating income up to a threshold (Can\$500,000 (about US\$393,000)).
- Enhanced investment tax credits for qualified expenditures on scientific research and experimental development.
- Deferral of an employee's taxable benefit arising from exercise of stock options.
- Shareholder entitlement to a capital gains exemption on a disposition of qualified small business corporation shares.

A CCPC is a Canadian corporation which is not listed on a stock exchange in Canada or elsewhere and which is not controlled, directly or indirectly, by one or more non-residents of Canada.

The Canadian federal government and certain provincial governments also provide tax credits to individuals resident in Canada or in specific provinces, who invest in certain labour-sponsored venture capital corporations (LSVCCs). LSVCCs are typically retail funds targeted at smaller individual investors. They are subject to restrictions on the companies in which they can invest and are in general more tightly regulated than other forms of private equity funds. LSVCCs are typically active in the domestic venture capital market segment only.

Canadian Provinces also offer tax credits aimed at smaller businesses in non-traditional industries, such as British Columbia's Small Business Venture Capital Act (RSBC 1996, c. 429). The tax benefits are of value only to Canadian taxpayers.

FUND FORMATION

4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?

The structure used almost exclusively in Canada as a vehicle for private equity funds is the limited partnership. Limited partnerships are governed by provincial law and may be formed under the laws of any province of Canada. Investors in a limited partnership are afforded limited liability so long as they do not actively engage in the conduct of the business, while the general partner (usually a company or another limited partnership) is subject to unlimited liability. It is unusual for Canadian private equity funds to be established using an offshore structure, although parallel vehicles are commonly established for non-Canadian investors.

5. For each structure identified in Question 4, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):

- So far as domestic investors are concerned.
- So far as foreign investors are concerned.

Limited partnerships are fiscally transparent under Canadian income tax laws. In a limited partnership with non-resident limited partners which receives a dividend or interest income from portfolio companies, all limited partners are subject to a 25% withholding tax on the income (subject to reduction under application treaties). For this reason, parallel vehicles are commonly created for non-Canadian investors. Otherwise, there is no difference in treatment for domestic investors and foreign investors under Canadian law.

6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

Limited liability corporations (LLCs) formed in the US are not tax transparent under Canadian law and instead are taxed as corporations. Accordingly, they are not generally used for investment in Canada. In such circumstances a limited partnership is typically the investment vehicle of choice.

7. Are a private equity fund's promoter, principals and manager required to be licensed?

Any person who is in the business of advising another about the sale or purchase of securities must be registered as an adviser. Accordingly, managers must be registered as advisers (unless there is an applicable exemption). Under the laws of certain jurisdictions only Canadian corporations or partnerships may be registered as advisers. A partner, director or officer of an adviser who advises on securities must also be registered as an adviser. A general partner of a private equity fund which is actively involved in managing its portfolio investments, and offshore managers, should not be required to be registered in this way. Recent changes proposed to the applicable national instrument may require a sponsor in fundraising mode to register as an exempt market dealer or hire a registered dealer to assist in the fundraising process. These new rules are not yet in force, and further clarification should be sought before fundraising in Canada.

8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

There is no concept of investment companies under Canadian law, and accordingly there is no regulation aimed specifically at investment companies. All issuers of securities must either:

- Clear and file a prospectus with the securities regulatory authorities of each province in which securities are being offered; or
- Issue such securities by way of a private placement under a prospectus exemption.

With a few exceptions, private equity funds sell securities by way of private placement.

The most commonly used prospectus exemptions available under Canadian law permit the issuance of securities to:

- Accredited investors (a class of persons which includes institutional and government investors, high net worth individuals and corporations).
- Any person purchasing securities as principal for a purchase price (or a commitment) of at least Can\$150,000 (about US\$118,000) in cash.

9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

In general, there are no restrictions on the nationality, age or minimum or maximum number of investors in most private equity funds. However, private equity funds which are LSVCCs may be subject to residency and other restrictions on investors. For example, the Employee Investment Act (British Columbia) requires that all investors in an LSVCC under the Act be individuals resident in British Columbia (see *Question 3*). Investors are also required to qualify under a prospectus exemption under securities legislation (see *Question 8*).

10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

The relationship between the investor and a private equity fund is primarily governed by a limited partnership agreement. Like most jurisdictions, the limited partnership agreement may contain some or all of the following provisions for the protection of investors:

- Investment restrictions including:
 - concentration limits;
 - geographic requirements;
 - diversification of industries;
 - limits on borrowing;
 - related party transaction restrictions.
- Reporting requirements.
- Provisions for the priority payment of distributions and clawback provisions in the event excess carry is paid to the general partner or investment manager.

- Creation of an advisory board to oversee conflicts of interest and provide approval of other matters specified in the limited partnership agreement.
- Key person clauses.
- Investor remedies including:
 - provisions allowing for early termination of the investment period or partnership term (both with cause and without cause);
 - provisions allowing for removal of the general partner or investment manager (both with cause and without cause).
- Preferences on co-investment opportunities.

Side letters are increasingly common in Canadian private equity funds and serve to fill in some of the gaps in the limited partnership agreement or to provide investor-specific protections.

11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory limits on the amount that may be invested in a private equity fund or the length of time such an investment must be held. Transfers must be made pursuant to available exemptions from the prospectus requirements.

INVESTMENTS

12. What are the most common investment objectives of private equity funds?

Private equity funds typically seek to achieve medium- to long-term capital gains by investing in, and taking an active role in the management of, a number of private investments. Investment objectives are different for different classes of funds:

- Growth funds typically have the widest mandate and focus on non-control equity investments, but may also participate in buyout or mezzanine transactions.
- Buyout funds invest for control of the entity and subsequent sale.
- Distressed funds are essentially a subset of buyout funds, using debt instruments or other mechanisms to acquire control.
- Mezzanine and merchant banking funds invest in debt instruments which typically pay a high rate of return and may also have an equity participation.
- Venture capital funds typically make non-control investments in technology companies with preferential participation rights over management.

The term of a private equity fund is usually ten years (often with a right granted to the general partner or manager to extend for two

or more years with investor consent). Capital is drawn down from investors during an investment period or commitment period, which is generally five years from the final closing, but which often may be extended for a further year with investor or advisory board approval.

13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

Equity and debt interests

The most common form of securities purchased in early stage or start-up investments are convertible preferred shares. These shares are usually entitled to a preferred dividend and to preference upon a liquidation event, and often have veto rights with respect to specific items which may be included in the portfolio company's constituting documents (see *Question 20*). Mezzanine investments are most frequently structured as debt which may be secured or unsecured and may be convertible or have a smaller equity component. Buyout transactions are often structured as both equity and deeply subordinated debt to create tax efficiencies, subject to Canadian thin capitalisation tax rules.

Restriction

Shares may not be transferred or issued unless qualified by a prospectus or unless a suitable prospectus exemption is available (see *Question 8*). In addition to the exemptions referred to in *Question 8*, shares of "private issuers" (companies with less than 50 shareholders and which maintain transfer restrictions in their governing documents) may be transferred within a specific class of persons (including current shareholders, accredited investors and directors, officers and employees of the company). However, any transfer of shares of a private issuer will generally require approval of the board of directors of the company, and the shareholders' agreement will typically contain additional restrictions on transfer.

BUYOUTS

14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Before the credit crunch, it was becoming increasingly common for buyouts of private companies in Canada to take place through an auction. The seller typically retains an independent financial adviser to manage the auction process. The financial adviser establishes the procedures for the auction with the goal of identifying a limited number of suitable potential purchasers of the business. Participants in the process are asked to sign confidentiality agreements which include standstill restrictions against making a bid outside the auction process. These participants are asked to submit final bids and a copy of the purchase and sale agreement, marked to show changes from the version prepared by the seller. The seller may then enter into final negotiations with one or more of the bidders. In recent months, buyers have been scarce, and are once again gaining the upper hand.

While securities and corporate legislation apply to the form of transaction, there is generally no legislation which governs the auction process itself.

15. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?

Public to private buyouts of listed companies and income trusts in Canada are relatively common. Buyouts of listed issuers are governed by the securities legislation, which is largely uniform in each province in which there is more than a *de minimus* number of shareholders and by the Business Corporations Act or equivalent corporate legislation in the jurisdiction in which the target company is incorporated. In addition, the transaction must comply with the rules of the Toronto Stock Exchange or other stock exchange on which the target company's shares are listed.

The most common structure for a buyout transaction is a plan of arrangement or amalgamation or, less frequently, a two-step process consisting of a takeover bid followed by a plan of arrangement or amalgamation.

Plan of arrangement buyouts

Transactions structured as a plan of arrangement or amalgamation require:

- The preparation and dissemination of a proxy circular to the target company's shareholders.
- The holding of a meeting at which the target company shareholders vote on whether to approve the transaction.
- In the case of a plan of arrangement, court approval.

Canadian corporate legislation generally requires super-majority (for example, two-thirds or in some cases three-quarters) shareholder approval. Securities legislation may in certain circumstances require disinterested shareholder approval of the transaction.

It is also typical in these transactions to provide dissent rights to the target company's shareholders and to deliver to these shareholders a fairness opinion or valuation of the target, even where not explicitly required by law.

Private equity buyers typically favour the use of a plan of arrangement as it is a more flexible procedure allowing for tax structuring and ensures that the buyer acquires all of the outstanding securities of the target company (assuming that the shareholder vote passes and court approval is obtained).

Takeover bids

Takeover bids are less common in Canada and are most frequently used in a hostile takeover situation. As many private equity funds have restrictions in their governing documents on use of hostile takeovers, this structure is not often seen in private equity buyout transactions. Legislation imposes strict timing and pricing requirements on takeover bids and requires that all target shareholders be treated equally. A successful takeover bid is usually followed by a compulsory buyout (where 90% of shares have been obtained) or otherwise by an amalgamation squeeze-out transaction to acquire the shares not tendered.

16. What are the principal documents produced in a buyout?

Plan of arrangement or amalgamation

Buyouts which proceed by way of amalgamation or plan of arrangement are typically governed by a pre-acquisition or merger agreement. Additional principal documents, typically produced in a buyout structured as a plan of arrangement or amalgamation, include an information or proxy circular providing a detailed description of the transaction and voting agreements entered into between the buyer and principal shareholders of the target company (see *Question 15, Plan of arrangement buyouts*).

Takeover bids

Hostile takeover bids, by their nature, are not the subject of any agreement between the target and buyer. Friendly takeover bids typically governed by a support agreement between the buyer and target and often by additional support or lock-up agreements between the buyer and principal shareholders.

A takeover bid requires the preparation and delivery to target company shareholders of:

- A takeover bid circular by the buyer.
- A directors' circular by the target board.

Private transactions

Where the target business is not publicly listed, the transaction is typically governed by a share or (less frequently) an asset purchase agreement. There are also typically employment agreements with key management personnel and a non-competition agreement with the seller(s).

Additional documents may be required in forming and financing the acquisition vehicle.

17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

Private equity purchasers typically obtain a broad range of representations and warranties regarding the target business, although these representations and warranties are generally truncated in the event of an auction purchase or where the seller is itself a private equity fund. Where the target business is publicly listed, these representations and warranties typically expire on closing. Where the target is not publicly listed, the representations and warranties are sometimes supported by a holdback of a part of the purchase price to satisfy any claims for breach which may arise following closing. Indemnities for breach of representations are also typically capped in amount and expire after a suitable survival period.

Interim operating covenants

Buyers typically require interim operating covenants governing the operations of the target business between execution of the purchase document and closing. A broad range of conditions to closing is also demanded, usually including a material adverse change

condition. It is not uncommon for there to be a post-closing adjustment to the purchase price in acquisitions of private companies.

Reverse termination fees

Private equity buyers rarely require a financing condition to the purchase. However, they are increasingly demanding and receiving a reverse termination fee of 1% to 3% of the equity value of the business as the sole remedy of the seller for the buyer's failure to complete, making the transaction similar to an option.

18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

Directors and officers of portfolio companies owe a fiduciary duty to their company, to act in the best interests of the company, which generally includes a duty not to improperly use their position to gain a personal advantage. Management teams are free to pursue buyouts only if they obtain consent from those directors who are independent of all interested parties (which typically will exclude any director who is a member of management or who is a related party of the potential buyer). It is commonplace in Canada for companies considering buyout transactions to form a special committee of the board of directors to consider the proposed transaction and any alternatives.

19. What terms of employment are typically imposed on management by the private equity investor in an MBO?

Typical terms of employment for management include:

- Exclusive time commitments.
 - Restrictive covenants, including non-competition, non-solicitation and confidentiality requirements.
 - Stock option or other deferred compensation mechanisms intended to act as an incentive to the individual to remain with the company (so-called golden handcuffs).
 - Termination or severance provisions, the length of which vary widely depending on the office held by the employee and his seniority.

Shareholders' agreements may also impose restrictions on management preventing them from transferring their shares in the company or requiring them to sell their shares on an exit from the company.

20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?

Private equity investors typically obtain some or all of the following rights to ensure a level of management control over portfolio companies:

- Board and committee representation in the portfolio company (or failing such representation, observer status).
- Quorum requirements for board meetings ensuring that board meetings may not be held without investor participation.
- Veto rights with respect to specific items (requiring special majority approval at either the board or shareholder level).

These rights are typically provided in a shareholders' agreement and certain rights are also frequently embedded in the portfolio company's articles (particularly the investor approval requirements, which may also be framed as class approval rights for particular classes of shares). Shareholders' agreements usually also contain information rights and provisions, such as restrictions on share transfers, drag-along rights and tag-along or piggyback rights that provide the private equity investor with a measure of control over exit transactions.

21. What percentage of the finance will typically be provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?

The percentage of finance provided by debt varies depending on a variety of factors including:

- Size of transaction.
- Market conditions.
- Risk profile of the transaction.
- Income tax considerations.

Due to the current difficulties in the financial markets, debt financing has become increasingly difficult to obtain and may be more expensive. As a result, buyout transactions have become less leveraged. There have been far fewer mega-deals completed since mid-2007.

22. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:

- Security?
- Contractual and structural mechanisms such as subordination?

Security

Security in a private equity transaction usually takes the form of a fixed charge mortgage over all real property and a floating charge on all personal property of the debtor currently held or acquired afterwards. Share pledges, whereby security is taken over the shares of operating subsidiaries, are the most common form of limited security.

Contractual and structural mechanisms

Guarantees are generally obtained from all operating subsidiaries, supported by security in the same form as discussed above. Debt providers usually enter into interlender agreements to establish priority of their various claims in a default situation. In addition, credit agreements typically provide restrictions on management of the debtor business and provide financial maintenance covenants. Structural subordination (debt financing at the operating subsidiary level) is also common.

23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this impact on the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Corporations may be incorporated in Canada under either the federal or provincial statutes. The rules regarding the provision of financial assistance for the purchase of shares in a company are prescribed by the statute under which the corporation was incorporated or continued. Historically, most Canadian corporate statutes had limitations on the ability of companies to provide financial assistance to a purchaser of shares. However, these restrictions have for the most part been curtailed or in some cases removed entirely. Federal and Ontario law provide no restrictions on financial assistance, while British Columbia and Alberta law require only that certain prescribed information regarding financial assistance be disclosed. However, Nova Scotia law prohibits the granting of financial assistance (including a guarantee) where there are reasonable grounds for believing that the company would, after giving the assistance, effectively be insolvent.

24. What is the order of priority on insolvent liquidation? Are debt providers given priority over equity holders by law or is priority purely a matter of contract and company constitution?

Debt providers have priority over equity holders in insolvent liquidations. The order of distribution on an insolvent liquidation can be summarised as follows:

- Tax and withholdings claims prescribed by statute.
- Claims of holders of secured debt.
- Expenses incurred in bankruptcy administration.
- Preferred claims prescribed by statute (including arrears of wages).
- Claims of holders of unsecured debt.
- Equity holders.

Debt holders may enter into priority agreements to establish priority as among themselves.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

Canadian Venture Capital and Private Equity Association (CVCA)

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Status. The CVCA is a non-governmental organisation.

Membership. The CVCA has over 1,500 members representing the majority of private equity sponsors in Canada.

Principal activities. The CVCA promotes the development of the Canadian venture capital and private equity industry by:

- Promoting sound public policy, including on tax, trade and securities issues to federal and provincial governments and regulatory bodies.
- Facilitating information exchange and communication in the industry.
- Providing a forum for professional development.
- Encouraging Canadian and foreign venture and private equity capital.
- Encouraging individuals to invest in, and provide advice to, early stage Canadian growth companies.
- Enhancing ties with leading venture capital/private equity associations around the world, particularly in the US, Europe, Australia and Israel.

Published guidelines. The CVCA has released valuation principles and guidelines based on the consideration of international standards in industry consultation.

Information sources. Thomson Financial has developed a comprehensive database for Canadian venture capital and private equity transactions for the Canadian market (www.canadavc.com).

Financial Post Crosbie. Crosbie & Company Inc. (www.crosbieco.com) provide specialised investment banking services for the middle markets.

PricewaterhouseCoopers LLP (www.pwc.com) undertakes regular surveys of IPO activity in Canada.

25. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

Most mezzanine transactions include a form of equity kicker (a warrant or an option to buy equity, attached to certain debt), through a small equity holding, warrants or conversion rights.

PORTFOLIO COMPANY MANAGEMENT

26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Management of portfolio companies are typically required to maintain an equity interest in the portfolio company (usually common shares) and also often participate in deferred compensation plans such as stock option or share purchase plans.

27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

Employees, consultants and advisers who exercise stock options are generally taxed at a reduced capital gains rate so long as the exercise price of the option is not less than the market price of the underlying shares as at the date of grant. If the company qualifies as a CCPC as at the grant date, income tax can be deferred until sale of the underlying shares (see *Question 3*).

EXIT

28. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buy-out)? What are the relative advantages and disadvantages of each?

The most common forms of exit are, in order:

- **Sale to a strategic investor.** This form of exit generally has the advantage of being less expensive and time-consuming than an IPO, although the financial rewards are generally less than for a successful IPO. No IPOs were completed in Canada in the fourth quarter of 2008, so sale may be the only practical alternative in the current environment. Sales have the potential disadvantage of being required to meet competition law requirements.
- **Sale to a private equity investor.** This form of exit has much of the same advantages and disadvantages as a sale to a strategic investor, with the added advantages of generally requiring much less stringent representations as to the underlying business and being more likely to avoid scrutiny under competition laws.

- **Recapitalisation.** Before the credit crisis, recapitalisation or borrowing to repurchase equity or pay dividends was available as a way of achieving a full or partial exit.
- **Initial public offering (IPO).** Until recently, the most successful structure for IPO exits in Canada was the creation and flotation of the income trust. However, in 2006 the federal government eliminated the preferred tax treatment of income trusts. This, combined with the current volatility in equity markets, has led to a significant drop in the number of successful IPO exits. A successful IPO generally results in a greater return on the private equity fund's investment. However, an IPO is expensive, time-consuming and may not result in the total sale of the fund's investment. Any remaining shares held by the fund may be subject to ongoing resale restrictions. Historically, it has not been uncommon for IPO exits to be conducted on the US markets or on both Canadian and US markets concurrently.

29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

The form of exit used to end an investment in an unsuccessful company depends to a certain extent on the type of investment. The most common forms of exit are the following:

- **Fire sale.** The assets of the company are sold at a significant discount from the initial valuation, the advantage being that the fund receives a return of at least some of its initial investment, although buyers may be difficult to identify.
- **Restructuring.** This generally involves additional investors making an investment in the company at a lower valuation and taking securities which rank ahead of those issued in the initial round. This has the advantage of keeping the business afloat without requiring the fund to make any additional investment (or a lesser investment than would otherwise be the case), but dilutes the fund's interest and thereby reduces its possible return on investment.
- **Bankruptcy or court-approved plan of arrangement.** This has the advantage of giving court protection to the fund's nominees on the board. The disadvantage is that shareholders are unlikely to receive any return on their investment unless they also hold debt.

In addition, where the private equity fund holds secured debt in the company, it may realise on this security (which may in turn force the company into bankruptcy).

CONTRIBUTOR DETAILS

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