Going Private Transactions in Canada

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**Introduction**

A going private transaction is a transaction or series of transactions which has the effect of transforming a public company into a private company and thereby eliminating the public shareholders.

A going private transaction is typically proposed for one of two reasons:

(a) the management of the target company or one or more shareholders of the target company wants to buyout the other public shareholders and take the company private; or

(b) a third party proposes to acquire the target company either with or without the support of management or a group of shareholders.

The first type of transaction is often referred to as a management buyout or MBO. Each of the types of transactions is often referred to as a leverage buyout or LBO, as the bidder will often try to incur a significant amount of debt (taking advantage of the assets and credit rating of the target company as collateral) in structuring the going private transaction. However, the recent credit crunch renders more difficult highly leveraged acquisitions.

This paper is intended to provide an overview of the basic considerations that acquirors, the target company, its management and directors will have to take into account in pursuing a going private transaction. Note that the rules governing going private transactions are very technical in nature and need to be assessed carefully in the case of each going private transaction.

**Why Go Private?**

**Increased Interest in Going Private Transactions**

In recent years we have witnessed a significant increase in the number of persons interested in pursuing going private transactions.

Analysts and commentators have suggested there are a number of factors that have contributed to this increase:

1. **Depressed Share Prices** The late 1990s saw a significant boom in the number of companies going public and a substantial increase in stock market prices. With the subsequent decline in the public markets many of the smaller public companies have had trouble justifying the costs associated with being public.

2. **A Litigious Environment** Corporate scandals have created a more litigious environment for public companies as well as their directors and officers. Regulators are more vigilant in
pursuing potential offenders and we have seen a growth in class action litigation brought on behalf of minority shareholders. The recent coming into force in most Canadian provinces of a secondary market civil liability regime should facilitate class action litigations by investors who purchase or sell securities in the secondary market where there is a misrepresentation in an issuer’s disclosure record or failure to make timely disclosure.

3. **Increased Regulation Resulting in Increased Cost**  The cost and complexity related to being a public company have increased significantly as a result of the passage of the Sarbanes-Oxley Act in the United States and the adoption in Canada of significant new national instruments and other rules mandating (i) enhanced continuous disclosure, (ii) certification of financial statements, disclosure controls and procedures and internal controls, (iii) enhanced audit committee and auditor oversight requirements, and (iv) corporate governance disclosure requirements.

4. **Out of Sight — Out of Mind**  If an issuer’s stock has declined and fallen out of favour it will most-likely be more thinly traded. Most likely there will be no or very limited analyst coverage on the stock and limited interest in the stock from institutional investors. A company in this situation will likely have very limited access to markets to raise additional capital. It will also be hampered in its ability to use its stock as currency to expand and pursue acquisitions.

**Cost of Being Public**

There are considerable costs associated with simply maintaining a public company. These include:

1. the costs of producing quarterly and annual financial statements, reporting on management’s discussion and analysis on financial statements, holding annual meetings of shareholders and making other requisite filings with regulatory authorities;

2. costs associated with retaining and compensating directors given the perception of greater exposure to liability in the public company context;

3. costs associated with auditors, law firms and other professional advisors;

4. costs associated with an investor relations department to maintain contact with investors, regulatory bodies and others within the financial community;

5. fees payable to securities regulators and stock exchanges; and

6. premiums for directors and officers liability insurance.
Other Possible Benefits of Being Private

In addition to the reasons discussed above, there are some less quantifiable reasons for a company to go private. For example, senior management of a public company is often focused on the next quarter’s results and other disclosure and compliance requirements. This can draw attention away from managing the business. As a private company, management is potentially less distracted from long term goals and can better concentrate on its operations.

In addition, a going private transaction can provide liquidity to the public shareholders of the target company. This will be particularly relevant if the company is thinly traded or has limited analyst coverage. Often the going private transaction is at a premium to recent market prices.

Some private equity investors suggest that going private will provide the target company and its management with access to financial and operational expertise that it may not have access to as a public company. Many private equity investors then draw upon internal and external advisors to assist in the expansion and growth of the target company once it is private.

Further, a public company with a low price to earnings ratio might become targeted by possible buyers. Management of a non-controlled public company may consider taking the company private before it becomes a possible take-over candidate.

Of course, a going private transaction will put the non-controlled public company “in play”. This may precipitate bids from others so the board of directors will have to weigh this factor.

Going private transactions can be expensive, complex and time consuming. Legal, accounting and financial advisory fees can add up quickly.

If you are considering a going private transaction by way of amalgamation or plan of arrangement you should assume that it will take at least three months to complete once you make the decision. This of course assumes that the process goes smoothly and there are no pot holes in the road. A contentious deal may take much longer. A going private transaction by way of take-over bid can be accomplished in a shorter period if 90 per cent of the shares are tendered to the bid. This can be accomplished in approximately 60 days. Also, unless exempted, you should allow for an additional three weeks for the preparation of a formal evaluation. The procedures are discussed in further detail below.

The Regulatory Framework

Going private transactions involve an interplay of both corporate and securities laws. The effect of the transaction in each case is that some shareholders will have their interest in the target company cashed out without the holder’s consent. Applicable corporate and securities laws do not prohibit going private transactions but instead place restrictions and obligations on the bidder, the target company and related parties engaging in a going private transaction. From a policy perspective, they are
intended to safeguard the interests of minority shareholders and ensure that shareholders are treated fairly in the process of a going private transaction. The scope of the following discussion is limited to corporations governed by the Canada Business Corporations Act (the “CBCA”).

In order to undertake certain fundamental changes (which would apply in the case of most going private transactions) a corporation must, for each class of outstanding shares, obtain the approval from holders of at least two-thirds of the shares represented in person or by proxy at a duly called meeting of shareholders. In the case of each fundamental change which gives rise to a shareholder vote, a corporation is also required to grant each shareholder a dissent or appraisal right.

Applicable provincial securities laws in Canada regulate take-over bids. In addition, Multilateral Instrument 61-101 of the Autorité des marchés financiers (“AMF”) and the Ontario Securities Commission (“OSC”), imposes additional requirements on insider bids and business combinations which apply in the context of many going private transactions.

The AMF and the OSC regard it as essential, in connection with insider bids, business combinations and other related party transactions, that all security holders be treated in a manner that is fair and that is perceived to be fair. To this end, securities regulation (i) generally mandates equal treatment of shareholders, (ii) requires additional disclosure regarding the background and approval process undertaken by a target company which are intended to focus the board of directors on their fiduciary duties, (iii) requires minority shareholder approval in certain instances, and (iv) in some cases, requires independent valuations.

**Techniques for Going Private in Canada**

In Canada, a going private transaction can take a number of forms. The most common ones:

(a) an amalgamation of the target company with the party pursuing the going private transaction or its affiliate;

(b) a take-over bid which may or may not be followed by a compulsory acquisition of the shares of those holders who do not accept the bid (subject to certain thresholds) or a second stage going private transaction; or

(c) a plan of arrangement.
Amalgamation

An amalgamation is a statutory means of combining two or more companies into a single company. As a going private technique, an amalgamation may be used on its own or as the second stage to a going private transaction commenced by take-over bid (discussed below). There are a variety of ways in which a going private amalgamation may be structured but a simple structure is as follows:

1. the bidder incorporates a new subsidiary in the jurisdiction of the target company (“Bidco”);
2. the shareholders of the target company vote to amalgamate the target company with Bidco;
3. on amalgamation the bidder receives all of the voting shares of the amalgamated company in exchange for its shares in Bidco and all the shareholders of the target company receive redeemable shares in the amalgamated company; and
4. the redeemable shares of the amalgamated company are immediately redeemed for cash or whatever other consideration is agreed upon.

This leaves the bidder as the sole shareholder of the amalgamated company.

The primary document involved in completing a going private amalgamation is a proxy circular prepared and delivered to shareholders of the target company (which would generally contain a formal valuation and/or a fairness opinion as further discussed below). Under the CBCA, an amalgamation must be approved by not less than two-thirds of the shares represented in person or by proxy at a meeting of shareholders. If there are multiple classes of shares in the target company, each class must approve the amalgamation. In addition, if the transaction involves a related party of the bidder or the target company, a separate approval by a majority of the minority shareholders of the target company may be necessary. This is discussed below in further detail.

One of the benefits of using an amalgamation as a going private technique is that it accomplishes the desired result in a single step. Practically speaking, as it requires cooperation from the target company, a hostile bidder cannot use the amalgamation or plan of arrangement approach.

Take-over Bid

A take-over bid can be made on a basis where support for the bid is solicited from the target company’s board in advance, or it may be unsolicited, in which case if it is not supported by the target board it will be considered hostile. It would be unusual for a going private transaction to proceed by hostile bid if the bidder will want to retain management after the target company becomes private.

It is not uncommon for a take-over bid to be subject to various conditions, however, it should be kept in mind that in Canada a take-over bid may not be conditional on financing so the bidder must have its
financing in place prior to commencing the bid. This requirement will be met if the offeror reasonably believes the possibility is remote that it will not be able to pay for tendered securities because of a financing condition not being satisfied.

Most bids in Canada will contain a condition that a minimum number of shares be tendered to the offer. This is so the bidder has a level of comfort that a certain level of approval is obtained before the bidder is required to take up the shares tendered to the bid. If the bidder has more than two-thirds of the outstanding shares of the target company after the take-over bid, generally it may proceed with a second stage amalgamation in order to acquire the shares not tendered to it in the bid. The steps to this second stage amalgamation will generally be the same as discussed above in the context of a single stage amalgamation with certain exceptions. The minority approval requirements (discussed below) still apply in respect of a second stage amalgamation. However, provided certain conditions are met, a bidder can vote the shares acquired through the take-over bid, including any locked-up shares, in favour of the second stage transaction. Any shares held by the bidder prior to the commencement of the bid cannot be voted as part of the minority.

Where the take-over bid is made by an insider (which generally means it is made by or with the involvement of one or more 10 per cent holders, management or directors) a formal valuation and enhanced disclosure will generally be required. The scope of the formal valuation requirements is discussed below.

If the offer is accepted by 90 per cent or more of the securities of the target company not already owned by the bidder then the bidder can take advantage of the compulsory acquisition provisions under applicable corporate law to acquire the remaining shares. The shares of the target company held by the bidder at the date the bid is made are excluded from the 90 per cent calculation. The compulsory acquisition procedure is generally less time consuming and less costly so it is in the bidder’s interest to obtain the 90 per cent approval threshold.

**Plan of Arrangement**

A further technique for going private is pursuant to a statutory plan of arrangement. Through the plan of arrangement a company which is solvent can pursue a broad range of fundamental changes under a single transaction. There are however a couple of important conditions. Firstly, a target company proposing to go private by plan of arrangement must obtain court approval to proceed. Secondly, as part of that court approval, the company must be able to demonstrate that it would not be practical to effect the fundamental change under any other provision of the applicable business corporation statute.

The process for conducting a going private plan of arrangement is not dissimilar from the amalgamation scenario with the exception of the necessary court approval.
Plans of arrangement are generally used in transactions that requires steps that go beyond the mere acquisition of the target company shares, such as arrangements with debentureholders, or where bids or amalgamations do not work well because of jurisdictional issues.

**Formal Valuations / Fairness Opinions**

A formal valuation is a report prepared by a qualified and independent valuator that sets out an opinion as to the value or range of values of securities based on recognized valuation techniques. A formal valuation will generally be required in the context of a going private transaction where the acquiror is an insider or person acting jointly or in concert with an insider of the target company. The theory is that if insiders are on the acquiror’s side and are involved in pricing the transaction, shareholders should have the benefit of an independent valuation.

There are a number of exemptions from the formal valuation requirements which may be applicable in a going private transaction. The following are some exemptions that may be available:

1. If the bidder has previously negotiated an arms length agreement with a significant shareholder at a price that is at least equal in value and in the same form as the consideration to be paid on the going private transaction.

2. For a business combination, if the target company’s shares are not listed on a senior exchange (for example, the TSX Venture Exchange is not a senior exchange) the going private transaction will also be exempt from the formal valuation requirements.

The board of directors and in certain cases an independent committee of the target company will retain the valuator and provide the supervisory rule.

In addition, it is customary for the board of directors of the target company to receive from its financial advisors a fairness opinion confirming that the consideration offered pursuant to the going private transaction is fair from a financial point of view to the targeted shareholders.

**Majority of the Minority**

In addition to obtaining two-thirds approval of holders of each class of shares in the target company as required by applicable corporate law, Multilateral Instrument 61-101 requires that any business combination (other than in circumstances which do not involve related parties) must also be approved by a majority of the minority shareholders present in person or by proxy at the applicable meeting. The minority is determined by excluding any shares of the applicable class held by the target company, any related party to the target company being treated differently, the bidder and any joint actors.

The requirement to obtain approval by a majority of the minority is modified for a second stage amalgamation transactions which is preceded by a takeover bid provided (i) certain disclosure is made
in the takeover bid circular, and (ii) the bidder and the target company follow certain procedures following completion of the bid. In such circumstances shares acquired by the bidder as part of the takeover bid can be voted as part of the “minority” in a second stage transaction.

Corporate Governance

Special Committees

In negotiating a going private transaction involving a related party (which will be the case in most instances if management or others related to the target company are to remain involved) it is good practice (and mandatory for an insider bid where a valuation is required) to establish a special committee of independent directors to safeguard against any real or potential conflict of interest or information advantage or other situation that may be perceived to be unfair.

The special committee should consist of only directors who are independent from any related party to the transaction. A special committee will typically review any offer received from bidders and consider and make recommendations in the context of maximizing shareholder value. Generally, the mandate of the special committee does not include entering into a definitive agreement to give effect to a going private transaction. This is the responsibility of the broader board of directors. Rather, the special committee’s role is to supervise the process of considering alternatives, supervise the preparation of any formal valuation and making recommendations to the full board of directors.

The Role of Directors

In considering a going private transaction each director must keep in mind his or her duties to act honestly and in good faith with a view to the best interests of the target company and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The directors of the target company will need to assess whether the going private transaction is desirable or fair and in the best interests of the target company taking into account the interest of all stakeholders. In making this determination the directors should be assessing all of the material factors which they consider relevant. This will involve the considerations and conclusions reached by any special committee as well as any analysis provided by third parties engaged to assist the directors and the special committee in their deliberations such as a fairness opinion provided by an investment banking advisor and any valuation.

When a board of directors or special committee, as applicable, reaches a decision on a going private transaction, courts will generally respect its business judgment and not second guess its decision which, even with the benefit of hindsight, might not appear to be the best decision. A caveat to this is that directors in making their decision should do so after having carefully considered the advantages and disadvantages of the transaction and any available alternatives and avoid conflict of interests.
Conclusion

With the current economic and regulatory environment, a going private transaction could be beneficial for a significant number of small to mid size corporations, particularly with controlling shareholders, that have recently suffered a sharp decline in their share price. Targets with a good client base, good margins and good cash flows may also facilitate investment and financing opportunities. Management and investors should however be mindful of the significant time and cost associated with completing these transactions and should also be aware of the relatively complex regulatory framework.
Have you considered a going-private transaction?

For small to mid-size public companies

Why you should go private?

- to take advantage of the opportunities resulting from depressed share prices;
- to reduce costs, which are disproportionately high for small/mid-size public companies;
- to exit a highly regulated environment;
- to have an exit strategy for current shareholders or possible ways to achieve a transfer of business, more particularly with controlling shareholders;
- to have more privacy in running your business;
- to reduce liability for your officers and directors, and D&O insurance premiums;
- to increase operational flexibility and focus on running the business with a view to maximizing long-term value.

In going-private transaction for Québec public companies, our local experience and national strength works for you.

With offices in every major Canadian financial and business centre, McCarthy Tétrault is Canada’s premier law firm.

Please see the enclosed memorandum for more details concerning going-private transactions.

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