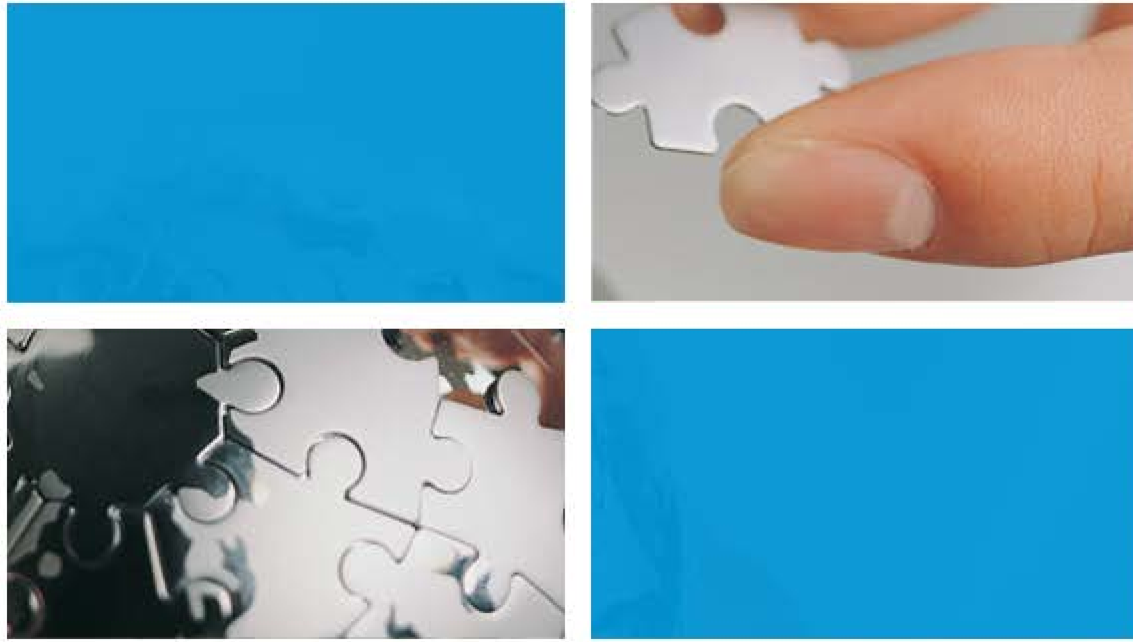

Acquisition of a Business
Legal Perspective

Rafal Wrzesien, Partner

Applied private Equity and Venture Capital
John Molson School of Business
November 29, 2014

gowlings
Lawyers • Patent and Trade-mark Agents

Overview

1. Asset or Share Deal?
2. Expression of Interest
3. Due Diligence
4. Acquisition Agreement
5. Related Agreements
6. Post-Closing – Director's Duties and Liabilities

gowlings

1. Asset or Share Deal?

What Are We Buying?

Assets

- traditionally portrayed as the "**Buyer's favourite**":
  - asset purchase allows Buyer to "cherry pick";
  - general assumption of liabilities avoided;
  - tax - Buyer can maximize tax deductions by allocating purchase price to assets in the following order:
    - Inventory
    - Depreciable Capital Property
    - Eligible Capital Property (Goodwill and other intangible assets)
    - Non-Depreciable Capital Property (land, shares, partnership interest)

Shares

- traditionally portrayed as the "**Seller's favourite**":
  - allows Seller to dispose of all assets and liabilities
  - tax - sale of shares results in taxation at ½ capital gains rate, whereas sale of assets can result in ordinary income from recapture of capital cost allowance (CCA) and profit on sale of inventory
  - If Seller is an individual, resident in Canada, may qualify for $750,000 lifetime capital gains exemption

gowlings

What Are We Buying?

Assets

- Yet Seller **may prefer an asset deal**:
  - may only wish to sell a division or line of business
  - tax - there may be losses to write off against any ordinary income from sale

Shares

- Yet Buyer **may prefer a share deal**:
  - tax - there may be loss carry-forwards in the target that constitute the main value of the transaction (used in the future to shelter income and reduce taxes payable)
  - Warning: rules restricting the use of losses

Tax Driven Election on Both Sides

- Tax issues tend to “drive the deal”
- Need to Ensure Consistency in the Agreements and Ancillary Documents
- SEEK TAX ADVICE EARLY
  - Step Memo for all steps of the transaction prepared by Tax Lawyers/Accountants

gowlings

Practical Considerations

- Objectives of the Parties
- Market Conditions (re: valuation of Target)
- Timing
- Is Buyer/Seller - Public or Private Company
    - Notices, authorizations to and from stock exchange securities commission (AMF), non-disclosure…

gowlings

Practical Considerations

- 3rd Party and Regulatory Consents and Approvals
  - Need to look at assignment provisions in contracts to determine if 3rd party consents required
  - Consider if business has any licenses or permits - transferability
  - Regulated business – approvals or notifications (i.e. public co, pharma, energy sector, etc.)

2. Expression of Interest

gowlings

So We Ran It Past The Tax Lawyers and Accountants (step memo). What Now?

- **Initial expressions of interest** (Letters of Intent (LOI) or Term Sheet) – usually initiated by Buyer
- A further formal acquisition agreement is always contemplated. Yet, depending on the circumstances, a court might hold an LOI or (less likely) a term sheet to be binding
- Generally speaking, both are meant merely to serve as a **base of negotiation for the material terms** (price, payment method, non-comp) - with certain exceptions, they are usually NOT meant to be binding

Is it a Binding Agreement?

- If there is any doubt, the courts will apply the following test:
  - Did the document establish the essentials of an agreement, with only the formal execution left to be accomplished?
  - Or was a further agreement a condition precedent to legal obligations?

Is it a Binding Agreement?

- The easy way to avoid the court deciding is to **be explicit in the document** itself as to which elements are intended to be binding or not.
- Rule: Not binding
- Exceptions:
  - Confidentiality
  - Public announcements
  - Non-solicitation of clients and employees
  - Responsibility for fees and costs
  - Obligation to act in Good Faith (Civil Code)

Objectives

- Access for due diligence purposes
  - the prospective Seller promises to allow the prospective Buyer the access needed to conduct a thorough due diligence review
- Confidentiality
  - in return, the prospective Buyer promises to maintain the confidentiality of the material reviewed – CRUCIAL for Privacy Laws
- Exclusivity (“No Shop, No Talk” clause)
  - the prospective Seller promises not to solicit other expression of interest, or permit others access for some negotiated period

Objectives

- Payment for **fees and costs**
  - LOI may not in itself form a binding contract, yet behavior in negotiating may induce the other side to believe, reasonably, that there will be a contract, leading to outlays and perhaps conferral of benefits to a party - in that case, the other party’s costs may be compensated
  - At the LOI stage, Buyer usually generates significantly higher costs (legal, tax, due diligence) – Buyer may wish to share the initial risk with Seller by introducing a **break-up fee** in the event of unilateral termination of negotiations (liquidated damages)

LOI vs. Term Sheet

- Term sheets are superficially much less formal
  - usually, they simply list in point form a set of basic, opening positions - a basis for negotiation
  - usually, they are not signed back by the recipient
  - perhaps more common in lending than acquisitions
- LOIs are much more formal looking - cast in the form of a letter agreement
  - letters of intent are signed back by the recipient

LOI and Term Sheet

- If term sheets and LOIs are **non-binding** on the essentials of the deal, **why bother** with them?
  - they are a valuable device to focus attention on the really vital points
  - they structure debate
  - legalities aside, they can exert a powerful influence on expectations and bargaining position.
  - **Moral suasion, fair dealing and good faith** remain relevant, and the words "**but that wasn't in the letter of intent**" carry substantial weight

3. Due Diligence

Objectives

- Investigate Current and Potential Liabilities
- Minute Book Reviews – can be extensive if target has long history or subject of several reorganizations/amalgamations
- Various Searches (i.e. litigation, registered liens, insolvency, IP, background checks, labour, tax, environment)

gowlings

Objectives

- Enables Buyer to:
  - Evaluate the information provided by Seller relating to the business and to the Target being sold
  - Assess potential risks and liabilities
  - Verify facts and assumptions about the business and the corporation
- DD generates the building blocks which help form the **foundation of the transaction** and shape the various representations, warranties, covenants, conditions and indemnities provided in the acquisition agreement.

Shares vs. Assets

- Asset Deal
  - Only the specific assets being acquired and the specific liabilities being assumed generally need to be investigated
  - Corporate minute book reviews are generally not conducted, Buyer will rely on legal opinions from Seller's counsel and supporting authorizing resolutions
- Share Deal
  - Investigations can be numerous and time consuming
  - Target and all of its assets and liabilities should be investigated
  - Minute books, share registers and corporate laws in the jurisdiction where Target is carrying on business should be reviewed

DD Request List

- Sent by Buyer to Seller and tailored to the type of business conducted by Target - generally includes:
  - Corporate documents, D&O, Financings, Finance & Tax, Material Contracts, Real Property, Environment, Equipment, Inventory, IP/IT, Licenses, Permits, Governmental Authorities, Customers/Suppliers, Litigation, Employment, Background checks, etc.

Electronic Data Room

- Involves transforming material into an electronic format then downloading on CD or secure website
- Pros
  - Reduces administrative burden when sharing high volumes of information with large teams located in various jurisdictions and time zones
  - Manage privacy obligations and access rights (view, print, download)
- Cons
  - Security breaches, costs, dependency on Data Room providers (often managed by the Broker)

Practical Considerations

- Provide a comprehensive and detailed due diligence request list adapted to Target
- Coordinate the different categories of due diligence investigations, i.e. legal, financial, tax, business, etc.
- Hold regularly scheduled meetings or conference calls to receive status reports from all groups
- Involve due diligence team in preparing the acquisition agreement (i.e. reps and warranties)

Common Problems

…when purchasing small/mid-size businesses

- Parties’ urge to **get things done fast**, forget the silly due diligence
- Lack of business and corporate records
- Parties want **informal agreement** without all those reps and warranties and indemnification obligations
- Sellers forget to mention things like shareholder loans, guarantees or inter-co debts

Common Problems

…when purchasing small/mid-size businesses

- Lawyers were conspicuously absent when certain things were done (splitting up parcels of land, entering important agreements, issuing shares)
- **Family members and execs.** of Sellers get a number of perks and sweetheart arrangements
- Dealings with **key customers or suppliers** done informally, based on handshakes, goodwill and trust – Seller should restrict access to them until closing is eminent

Common Problems

…when purchasing small/mid-size businesses

- USAs in place with rules to be followed
- “You lawyers are always raising road blocks – let’s just get this done”
- “We’ll fix that up after the closing”
- “What’s with your bill?”

Common Problems

…when purchasing small/mid-size businesses

- Review of the minute books reveals complete lack of proper corporate procedures and approvals throughout life of the target company
  - improperly appointed directors
  - no resident Canadian directors (not required - QBCA)
  - shareholders never approved fundamental changes
  - material agreements were never authorized
  - appointment of auditors
  - issuance of shares
  - payment of dividends…

Common Problems – Quick Fix?

- Leading to the desire for the quick fix – the “whitewash” resolution
- The “No matter what was done when by who, it’s all OK by us, there, all nice and legal, love, the shareholders” - that doesn’t really work.

Summary

Remain mindful of the connections between:

- the information uncovered in the fact finding process; and
- the acquisition agreement and related agreements

4. Acquisition Agreement

4. Acquisition Agreement

- Purchase Price / Payment Terms
- Reps and Warranties
- Indemnification
- Covenants
- Closing (sign and close vs. sign and close later)
- Termination
- Other Concerns

Purchase Price

- How do you intend to pay for this? Some permutations:
  - fixed amount - cheque at closing for the full amount
  - fixed amount - part at closing plus a promissory note
  - variable amount - purchase price adjustment using closing date audited financials (i.e. working cap adjustment) - perhaps with holdback in escrow
  - variable amount - earn-out

Purchase Price

- A simple cheque at closing would be nice, but…
  - even if the amount is fixed, Buyer may not have all the money required right now, and maybe Seller can live with that
  - the absence of current audited financials may make the present worth of the corporation difficult to assess
  - the true value of the corporation may be a question that only time can answer

Purchase Price

- Purchase price adjustments
  - a certain amount is paid at closing, pending closing date audited financial statements
  - once the audited financials are available (approx. 90 days from closing), the adjustment is made, with interest
  - an amount may or may not be placed in escrow to satisfy the adjustment (leading to complex mechanics re interest, excess amounts, escrow agent, etc.)
  - the parties may dispute the adjustment (usually through expert determination)

Purchase Price

- Earn-out model
  - a sum is paid at closing, with further payments to come over a negotiated period of time (usually not more than 3 years) for a negotiated portion of future profits
  - should be tied to covenant to manage business in reasonable, profit-maximizing fashion or to keep Seller involved in a management role for that period (i.e. prevent the transfer of any operations/profits to other entities of Buyer's group further to its consolidation efforts)

Purchase Price

- Earn-outs (continued)
  - **Tax issues** - Seek professional help!
    - amounts related to the earn-out will be treated as ordinary income from property under 12(1)(g) ITA, not capital gain
    - however there is some relief available if, among other requirements, the earn-out period does not exceed five years (see IT-426, and IT-462)
    - **Relief only available in share sales**

Purchase Price

- All sorts of variations on the simple model of a certified cheque up front
  - part payment by promissory notes
  - payment in installments
  - assumption of liabilities
  - payment with shares of Buyer (most common when Buyer is a public company – be careful with your securities law analysis here re private placements, free tradability, mandatory hold period)

Purchase Price

- A common device is cash (or cash and notes etc.) up front, with a portion held back
  - as noted, the holdback may be used to satisfy the purchase price adjustment
  - it may be used as a fund to satisfy the indemnification obligation
  - this requires an escrow arrangement with escrow agent (i.e. Computershare, law firm) – acting for the benefit of both parties based on strict instructions to pay upon delivery of certain documents or joint instructions

Purchase Price

- Another common feature is the deposit - a device to assure good faith and seriousness of potential Seller
  - used in the “sign, close later” model (see discussion to follow)
  - may be refundable or non-refundable (or a mix of the two)
  - if refundable, may be placed in an escrow
  - may also serve a break-up fee if Seller withdraws from the deal

Purchase Price – Assets vs. Shares

- The same payment alternatives are available in asset deals as share deals, but some of the mechanics of payment will be quite different
- First, because it's an asset deal, it will be necessary for tax purposes to allocate the purchase price among the assets being bought
  - a classic struggle between Seller and Buyer, whose interests are usually in perfect opposition
  - it will suit Seller to allocate in this order, best to worst: non-depreciable capital property, goodwill, depreciable property, inventory
  - it will suit Buyer to do exactly the opposite!

Purchase Price - Assets vs. Shares

- Allocation (continued)
  - because the allocation in an arms length deal is such an adversarial process, the CRA is likely to accept that it reflects true market values
  - naturally, it is important to ensure that the allocation reported by Seller and Buyer is the same
  - it bears remembering that the CRA is by no means bound to accept the allocation

Purchase Price - Assets vs. Shares

- Second, in an asset deal, certain types of assets might get special treatment
  - for example, it is not uncommon for there to be a "put" of uncollected accounts receivable back to Seller if they are not collected by a certain date following the closing, with a purchase price adjustment
- Third, the tax concerns may be quite different in structuring the consideration
  - beware in particular of earn-outs in asset deals, as the relief from 12(1)(g) ITA is not available in asset deals

Representations and Warranties (R&Ws)

- Generally the most important part of the agreement
- Hedging the acquisition risk of Buyer
- lots of pitfalls, qualifiers, legal issues
- in a major agreement, the reps and warranties can run for 60 pages

R&Ws

- Generally provided by selling shareholders and the Target (the latter only in asset deal)
- Buyer would want solidary (joint & several) liability
- If entire business being sold, **generally** allows Buyer to have recourse against a party with assets

R&Ws – Assets vs. Shares

- *Asset deal* – focus on the "business" being acquired, assets and liabilities used to carry on the business
- *Share deal* – focus on Target, its assets & liabilities and its operations
- Defining the representations in a share deal with reference to "the business" would narrow the scope of the representations

R&Ws – Risk Analysis

- From Seller's Perspective
  - The desire is to sell with as little on-going liability for the business sold
- From Buyer's Perspective
  - Seller has the most knowledge about the business or corporation, Seller should be responsible for on-going liabilities in the business that become known after closing, which were not previously disclosed

R&Ws – Methods of Allocating Risk

- Qualifications and Exceptions
  - “Knowledge” Qualifier
  - “Materiality” Exception
  - Best Efforts, Commercial Reasonable Efforts
  - Exception to Representations and Warranties
- “*<u>Except as</u> set forth in Schedule A, to the <u>Knowledge</u> of Seller, Target has no <u>Material</u> liabilities*…”

gowlings

R&Ws – Methods of Allocating Risk

- It is important to consider how the representations and warranties will factor into the indemnity provisions and what will be the remedy a Buyer may pursue, if any of the representations and warranties prove to be untrue
- *Buyer* – prefers representations and warranties to be drafted broadly
- *Seller* – prefers representations and warranties to be drafted narrowly

gowlings

R&Ws – “Knowledge” Qualifier

- Determine “Type” of Knowledge
  - Actual
  - Imputed
  - Constructive
- Determine “Whose” Knowledge is being referred to

R&Ws – "Materiality" Exemption

- Often left undefined
- Allows the definition to vary depending on the context in which it is used
- To provide more of an objective measure and create more certainty - a monetary threshold can be used
- A dollar materiality threshold often serves to identify important contracts to be reviewed during the due diligence process

Nature and Survival of R&Ws

- The survival period of the representations and warranties and the period post closing during which a Buyer may assert a claim under the indemnity provision for a breach of a representation and warranty, is one of the more critical provisions to be negotiated in the acquisition agreement
- For most representations Buyer should seek a survival period that at least permits the completion of 1-2 audit periods post closing (18-24 months)

Nature and Survival of R&Ws

- Exception to Standard Survival Periods Include:
  - Title to shares – unlimited
  - Fraud or gross negligence – usually unlimited based on applicable limitation period
  - Taxes (reassessment) – usually a period of time after last re/assessment period (approx. 5 years)
  - Pension or Environmental – longer than general representations and warranties (3-4 years)

Indemnification

- Obligation of one party (the "**Indemnifying Party**") to compensate another party (the "**Indemnified Party**") in the event of a claim for loss or damages
- For example, Seller may indemnify for:
  - undisclosed debts and liabilities (except ordinary course)
  - contingent liabilities that come due
  - tax assessments or reassessments
  - product liability claims
  - "all claims, demands, costs and expenses, including legal fees, in respect of the foregoing"

Indemnification

- Indemnity clauses can be very useful as they provide:
  - Risk protection for matters addressed in the representations and warranties and covenants
  - Procedure for making and defending claims
  - Indemnifying Party with rights of participation in the process
  - May resolve a stalemate between the parties when trying to resolve an allocation of risk between Seller and Buyer for a real or potential liability (i.e. known litigation, unknown outcome)

gowlings

Indemnification

- Important for the Parties to Consider:
  - The likelihood of a potential claim,
  - The creditworthiness of the Indemnifying Party, and
  - Whether the obligation of the Indemnifying Party to indemnify should be secured in some way
    - Holdback
    - Escrow
    - Third party guarantee

Indemnification

- Consider:
  - Deductibles
  - Thresholds
  - Caps
  - Imposing limits on the survival period
- Generally do not apply to core reps and warrantees (title to shares/assets, fraud, etc.)

Covenants

- A covenant is a promise about future behaviour, while a rep and warranty is a promise about past and current facts
- The covenants are usually set out separately
- Many govern the behaviour of Seller in the interval between signing the definitive agreement and closing the transaction, e.g.,
  - may reiterate the obligation to permit Buyer access for due diligence purposes
  - no transactions outside the ordinary course
  - no amendments to organizational/constating documents
  - do everything necessary to maintain truth of reps and warranties

Other Common Covenants

- To maintain confidentiality
- To assist in obtaining assignment of contracts (Seller/asset deal)
- To make offers of employment to current employees (Buyer/asset deal)
- To obtain consents or approvals as needed (including regulatory) (Seller)

Covenants - Qualifier

- A key qualifier you will see with covenants is “best efforts” – “Seller will make best efforts to…”
- “*best* effort” vs. “*reasonable best* efforts” vs. “*commercially reasonable best* efforts”
  - the impact of these different formulations is not as great as one might think, but now that lawyers are using them a court might infer that a difference is intended, so play it safe

When Do We Close?

- “Sign, close later” vs. “sign and close”
  - in the latter model, all the interim covenants just mentioned would need to be put into a binding letter of intent, or simply lived without (except for confidentiality and exclusivity as discussed previously)
  - the former model is more common in major deals; the eventual closing is conditional on certain events happening, and the closing can be called off even though the agreement is signed and binding

When Do We Close?

- Another wrinkle is the "effective date" model
  - you sign now, close later, but the date of signing is the "effective date", with Seller, essentially, running the business in trust for Buyer until the closing
  - Buyer is entitled to profits made, and must assume liabilities incurred, during interim period
  - The deal can still be called off

Termination – After Signing but Before Closing

- When should the parties, having signed the agreement, have the right to walk away?
- Generally, there will be two sets of circumstances creating a right to termination
  - prior to the closing, Buyer will have the right to terminate if Seller’s reps warranties and covenants are breached
  - both parties can walk away at the closing if stipulated closing conditions are not satisfied

Closing or Failing to Close

- Closing conditions will for the most part favour Buyer and will include
  - accuracy of reps and warranties and compliance with covenants and a “bringdown” certificate (both parties)
  - delivery of related agreements (discussed below)
  - absence of certain [material] adverse changes, (damage to assets, adverse legislation, legal proceedings to stop the deal)
  - delivery of legal opinions (both parties)
  - delivery of any required consents and approvals (regulatory and third party)

Termination

- If the right to terminate is triggered, the aggrieved party will usually have a right to "promptly submit a claim" for damages. Two key negotiating points:
  - quantum of damages - actual costs incurred vs. loss of expectation (but be sure what you want here)
  - litigate or arbitrate? This depends on which you think will impose the most discipline on the parties - consider the grim spectre of litigation – on the other hand, arbitration is a confidential process
- Consider negotiating a break-up fee for this purpose

Other Concerns

- *Competition Act* – Transactions reviewable by the Competition Bureau if:
  - transaction-size exceeds $82M (2014) AND
  - combined CDN assets or revenues of the parties exceed $400M (2014)
- *Investment Canada Act* – Transactions reviewable by Industry Canada if:
  - $5M direct investments $50M for indirect transactions
  - Exception - WTO member: $354M (2014)
- *These should be considered early!!*

gowlings

Complication in Share Deals: NI 45-102 and NI 45-106

- The shares of a private company are NOT exempt from securities regulation
- The current holder will have acquired the shares, most likely, under an exemption from prospectus and registration requirements, see Reg. 45-106 of the AMF
- The sale now will be a “first trade” of securities acquired under the exemption, and under Reg. 45-102 of the AMF the “first trade” will be a “distribution” – i.e., attract prospectus and registration requirements – unless certain criteria are met (which likely can be met)

Securities Law: Reg. 45-102 and 45-106

- If the “trade” is a “distribution” then you must find another exemption under 45-106. This is usually eminently do-able, but the analysis must be done! The target company may not qualify for “private issuer” status – it’s a question of fact; the buyer might not be an “accredited investor”; it IS possible to go offside these rules, and you must be diligent on this score
- Beware the false comfort of “person who is not the public”

5. Related Agreements

Confidentiality and Non-Competition Agreement

- not to be confused with the confidentiality and “no shop” obligations contained in LOIs
- these are intended to protect Buyer after the closing by preventing Seller from immediately starting up a competitive business
- negotiated along with the primary agreement and attached as a schedule
- delivered at closing
- note that the portion of the purchase price allocated to non-competition covenants in the SPA will be taxable as ordinary income, though there may be ability to treat some of it as capital gain under new rules (certainly not tax free anymore!)

Confidentiality and Non-Competition Agreement

- The confidentiality obligation will usually be perpetual
  - protection of confidential information is a vital interest that the courts will uphold
  - defining “Confidential Information” can be a tricky business - if acting for Buyer, be as expansive and comprehensive as possible
  - Seller will, however, want to argue for exceptions (publicly available, obtained independently)

Confidentiality and Non-Competition Agreement

- In a share deal, the confidentiality and non-competition agreement is in favour not only of Buyer, but of its group, including Target
- The agreement should include acknowledgments designed to ease enforcement, including injunctive relief (i.e. irreparable harm, inability of money damages to fully compensate, injunction an appropriate remedy)

Shareholders' Agreement

- Tailored to the Facts
  - What kind of business is it?
  - Is there a market for sales of shares of this business?
  - What is the relationship between the parties?
  - What role will each shareholder play?
  - Is one shareholder more legally or commercially sophisticated?
  - Is one shareholder wealthier?
  - Does one shareholder have a stronger bargaining position?
  - Where does the client see itself in 5 years? 10 years?
  - What are potential sources of conflicts?
  - Do any of the shareholders own other businesses?

Shareholders’ Agreement

- Unanimous shareholders’ agreement vs. shareholders’ agreement
- Right of first refusal vs. right of first offer
- Pre-emptive rights
- Puts
- Calls
- Drag-along
- Tag-along
- Shot gun
- Arbitration

Unanimous Shareholders’ Agreement vs. Shareholders’ Agreement

- Unanimous Shareholders’ Agreement
  - Unanimous, of course AND
  - Transferring certain powers and duties from the directors to the shareholders
- WARNING: Loss of limited liability by shareholders in relation to the transferred duties

gowlings

What is a Right of First Refusal?

- A liquidity mechanism by which a shareholder who wants to exit the company may sell its shares to a third party provided that is has obtained an arm’s length offer from that third party and has first offered to sell the shares to the other shareholders on the same terms

How Does it Work?

- Exiting shareholder must first obtain a bona fide arm's length third party offer for its shares
- Exiting shareholder must then give written notice to all other shareholders and must offer to sell to other shareholders on the same terms and conditions
- Alternatives:
  - If there are shares leftover after the other shareholders have bought what they want or can, the exiting shareholder may sell the leftover shares to the third party

    OR

  - If the other shareholders do not buy all of the exiting shareholder's shares, it may sell all of its shares to the third party

gowlings

RFRs

For exiting shareholder:

- Liquidity may be illusory – ensure that your client has other exit options
- Obtaining an arm's length third party offer may be difficult or even impossible

For other shareholders:

- The arm's length offer requirement gives them some indication of value for the shares
- The identity of the third party (and thus their potential fellow shareholder) is known from the outset

gowlings

RFOs

What is a Right of First Offer?

- A liquidity mechanism by which a shareholder who wants to exit the company may sell its shares to a third party provided that it has first offered them to the other shareholders
- Also called a “soft” right of first refusal

RFOs

How Does it Work?

- Exactly the same as a right of first refusal, but there is no requirement to obtain an arm's length third party offer
- The exiting shareholder is free to pick its price and terms of sale

RFOs

For all shareholders:

- Makes their investment more liquid

For exiting shareholder:

- Mechanism is easier and cheaper to initiate
- Can ask for a higher price than might be obtainable from a third party since the other shareholders may not risk a sale to a third party

RFOs

For other shareholders:

- Since they won't know the identity of the third party Buyer, be sure to include a category of buyers to whom the shares cannot be sold under any circumstances i.e., competitors
- Be sure to include a requirement that the terms of the third party sale are eventually disclosed so that they can confirm that the terms of the final sale were no more favourable than the original offer

What is a Drag-Along?

- A drag-along right (or right of forced sale) is a right to compel certain shareholders to sell their shares, or to approve a sale of assets, on the terms and conditions negotiated and agreed to by another group of shareholders
- A drag-along is intended to facilitate third party offers to buy a company and to prevent certain shareholders (usually the minority interest) from blocking such a transaction

Drag-Along

How Does It Work?

- The right is given to an identified shareholder group — can be identified by percentage or can include certain named shareholders
- In the share context, if the specified group receives and wants to accept an offer to purchase all of the shares of the company, it issues a notice to the remaining shareholders and they must sell their shares on the same terms and conditions

Drag-Along

For the majority:

- A drag-along right is an absolute “**must-have**”
- Be sure to leave the language as general as possible for flexibility (i.e., cash and non-cash consideration)
- Be sure to include power of attorney language to deal with uncooperative minority shareholders

Drag-Along

For the minority:

- Try to negotiate a minimum price that must be obtained before the drag is effective, but this is tough
- Limit reps to ownership only and on a joint basis (non-solidary / “joint not several” in *common law*)
- Limit indemnities to consideration received

What is a Tag-Along or Piggy-Back?

- A tag-along right (or piggy-back) permits a minority shareholder to participate in a sale of a majority shareholder's shares on the same terms and conditions
- A tag-along is intended to prevent a minority shareholder from becoming "stranded" in a company when a majority shareholder exits

Tag-Along

How Does it Work:

- Usually a tag-along right drives off of a RFR or RFO
- For example: if an exiting shareholder becomes entitled to sell its shares to a third party, the minority shareholder (who chose not to buy the exiting shareholder's shares in the RFR or RFO) may choose sell to the third party on the same terms and conditions
- Exiting shareholder may not complete its sale to the third party, unless the third party agrees to buy the minority shareholder's shares on the same terms and conditions

gowlings

Tag-Along

For the majority shareholder:

- Resist this as it creates an additional hurdle for the disposition of a majority shareholder's shares in a RFR or RFO context
- If a tag-along is agreed to, try to limit its application to certain defined circumstances such as a change of control

Tag-Along

For the minority shareholder:

- An absolute “**must have**” – especially for the financially-challenged shareholder who will never have the resources to participate in a RFR or RFO
- Consider whether a shareholder can tender some of its shares or must tender them all

Employment Agreements

- Another common agreement employs Seller as a consultant following closing
  - it will sometimes be the case that Buyer requires Seller's expertise for a transitional period
  - form of comfort to Seller with respect to the earn-out payments post-closing
  - sometimes such agreements are merely a device to defer payment of a portion of the purchase price
  - get tax advice on this

6. Post-Closing – Directors' Duties and Liabilities

gowlings

6. Directors' Duties and Liabilities

Introduction

- Becoming a Director
- Liability Overview

Defenses

- Due Diligence
- Indemnification
- Liability Insurance

The CBCA

- Duty of Care
- Fiduciary Duties
  - Best Interests of Corporation
  - Self-Dealing
  - Disclosing Conflicts
- Oppression Remedy

Other Acts

- Environmental Law
- Labour Law
- Securities Law

Conclusion

gowlings

6. Directors’ Duties and Liabilities

You’ve Decided to Become a Director

But with great power comes great responsibility

- Shareholders are generally insulated from the losses of the company beyond their initial investment
- Directors have unlimited liability in certain circumstances

Directors who do not follow certain laws put themselves at risk

- However, many of the laws that include personal liability for directors also include **legal defenses**
- The most common is the **due diligence defense**
  - If the director took reasonable care, he or she may not be liable

gowlings

6. Directors' Duties and Liabilities

Due Diligence Defense

Protects well-intentioned directors from overzealous litigants

Practical Tips for Managers and directors

- Ask questions and stay informed
- Attend meetings when possible
- Ensure proper minutes are maintained
- Know the capabilities of the people to whom you are delegating
- Understand the regulatory framework (if any) under which your corporation operates

gowlings

Indemnification of Directors

Corporations can also indemnify their directors against certain types of liability

- The director must have acted "honestly and in good faith with a view to the best interests of the corporation" in order to be indemnified by the company
- In cases where fines would be assessed, the director must also have had "reasonable grounds for believing that his [or her] conduct was reasonable"

The result of this is that indemnification exists only in a few instances that would not already be covered by the due diligence defense

Liability Insurance

While indemnification is limited, corporations can purchase liability insurance for directors

The price of insurance is governed by:

- The likelihood of a director being found personally liable and
- The extent of the expected personal liability

The result of the recent increases in the prevalence of directors' liability has been higher prices for liability insurance

Practical Tips:

- While the CRA has yet to issue an interpretation bulletin on the matter, it appears that premiums paid on liability insurance can be deducted as a business expense
- Liability insurance will vary based on the industry and the firm itself, so if you're facing high premiums, that's a good indication that you're at a higher risk of being personally liable

Duty of Care

Directors are required to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"

- This is known as the duty of care

What constitutes "comparable circumstances"?

- It changes based on each director's experiences
  - It may be higher for inside directors than for outside directors
  - It may be higher for directors on committees than for those who are not
  - It may be higher for lawyers, accountants and for experienced businesspeople than for the average person

Practical Tips

- Admit when you don't know something as opposed to guessing. The court looks far less favorably on an expert that makes a mistake than a novice.
- At the same time, keep track of what you are supposed to know. If something goes over your head, seek out the explanation that you need to be comfortable making a decision.

Fiduciary Duties – Best Interest of Corporation

The definition of pursuing the "best interest of the corporation" has evolved over time

- It formerly meant acting in the best interest of all shareholders as a group
- Recently, the Supreme Court has included the language "as a good corporate citizen" into its analysis of the best interest of the corporation

The current standard is somewhat unclear

- To what extent must other stakeholders be considered?
- How should boards deal with conflicts between stakeholder interests?

Practical Tips

- Shareholders should still be your primary interest
- However, be aware of the effect your decisions will have on different stakeholders
- If the corporation will be making a decision that has a significant negative effect on one stakeholder, note that this effect has been considered and, where possible, note the rationale for the decision

Fiduciary Duties – Loyalty & Conflicts of Interest

As directors, individuals sometimes face opportunities for gain that would not have otherwise been available

- Any opportunity that is discovered in the course of a directorship should be made available to the company

What should a director do when the company refuses to follow up on an opportunity?

- Can he or she pursue it instead?
- What duties does he or she owe to the company?

The courts favour considering multiple factors rather than a single test

Practical Tips

- Disclose your potential to gain from an opportunity the company is considering
- Do not interfere with the decision-making process
- Do not resign from your position while the decision-making process is ongoing to free yourself to pursue the opportunity
- Do not assume that you can never pursue a corporate opportunity

gowlings

Fiduciary Duties – Self-Dealing

In some cases, the director may be the owner of an asset that the corporation wishes to purchase

- This situation creates conflict between the director’s desire personally to achieve the highest price possible for his asset and his desire to get the lowest price possible for the asset on behalf of the corporation

Fortunately, the legislative branch has set out the rules for self-dealing

- Any director who has a “material interest” must not attend any meeting about the transaction nor cast any votes on the transaction

Practical Tips:

- Talk to corporate counsel about the correct steps to take
- Stay out of meetings on the transaction
- Ensure your exclusion from the meeting is reflected in the minutes
- If a meeting unexpectedly brings up the transaction, excuse yourself
- Self-dealing may not just encompass yourself, but also people with whom you have a material relationship

gowlings

Oppression Remedy

The Oppression Remedy is a catch-all provision for generally unfair behaviour

- Limited to present and former shareholders and directors…
  - …or any other complainant the court deems fit…
- Limited to oppressive conduct…
  - …or conduct that is unfairly prejudicial or just unfairly disregards an interest…

The oppression remedy has the potential to be quite broad

What does this mean for directors' personal liability?

- The court must find that specific acts by the director in question engages oppression remedy
- The court must also find that a monetary order against the director would be the proper way to rectify the situation

Where has it been applied?

- Application has so far been limited to small, closely held companies
- Director must be "sole and directing mind"

Environmental Law

Directors who either personally commit an environmental offense or takes positive steps that enable the commission of an environmental offense, will be personally liable

Includes:

- Discharge of a contaminant
- Failure to notify of discharge
- Failure to restore natural environment in the event of a spill
- Obstruction, giving false information, etc.
- Not properly installing or maintaining equipment

Being found to be in contravention of the EQA can result in fines of up to $1,000,000 for directors and officers ($6,000,000 for corporations) and/or 3 years in prison – fines double and triple upon repeat offences

Practical Tips:

- Take action when dealing with environmental issues
  - Don't wait for a spill and then react
- If environmental breaches do occur, come forward with them
- Keep records of what environmental systems are in place and whose job it is to maintain them
  - Follow up with that person periodically

6. Directors’ Duties and Liabilities

Area Of Liability – Labour Law	Practical Tips
Wages • Directors are liable for six months wages of all employees in the event that the company fails to pay them • If the company goes bankrupt, directors can potentially be on the hook for a substantial monetary penalty	Wages • Make sure that wages get paid first • Know that resigning is not sufficient to protect a director from this liability
Health & Safety • If directors do not take adequate steps to protect the employees from work-related hazards, they may be found personally liable • There are provisions under the *Criminal Code* that open up directors to potential jail time if they do not take adequate steps to protect their employees	Health & Safety • The fact that a job is dangerous does not prevent employers from having a duty to take steps to mitigate that danger • Industry best practices are a good starting point, but directors should address their minds to what steps they can take to make the employee experience safer • Delegating the maintenance of a safe workspace will only be effective if the delegate has sufficient authority make the changes that will protect employees

gowlings

6. Directors' Duties and Liabilities

Area Of Liability - Securities Law	Practical Tips
Misrepresentations • If directors sign-off on public disclosure that contains misrepresentations, they may face personal liability	Misrepresentations • If you discover a misrepresentation, report it immediately • If you are relying on experts, have a good reason to trust their judgment • If you are relying on other public documents, have a good reason to trust them
Insider Trading • If directors engage in insider trading, they may face personal liability	Insider Trading • If you come into contact with knowledge that the general market does not have, you should not trade on it • Passing along that information to someone else can expose you to as much liability as acting on it yourself
General Liability • If directors provide instructions in contravention of the Securities Act, they may face personal liability	General Liability • New National Instruments are released frequently, so talk to corporate counsel about the requirements you face

Questions?

gowlings

Thank You

Rafal Wrzesien, partner
514-392-9539
rafal.wrzesien@gowlings.com

gowlings
Lawyers • Patent and Trade-mark Agents