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Private Equity in Canada: Market and Regulatory Overview

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A Q&A guide to private equity law in Canada.

The Q&A gives a high level overview of the key practical issues including the level of activity and recent trends in the market; investment incentives for institutional and private investors; the mechanics involved in establishing a private equity fund; equity and debt finance issues in a private equity transaction; issues surrounding buyouts and the relationship between the portfolio company's managers and the private equity funds; management incentives; and exit routes from investments. Details on national private equity and venture capital associations are also included.

Market Overview

1. What are the current major trends and what is the recent level of activity in the private equity market?

Market Trends

Canada has a mature private equity (PE) market that is closely integrated with that of the US. Many US funds invest in Canada, either directly or through add-on acquisitions by their portfolio companies, and many Canadian funds and other PE investors deploy capital in the US and internationally.

The most active PE investors in Canada include not only typical privately managed closed-funds, but also the PE arms of pension funds and Canadian banks, labour-sponsored funds, and provincial and federal government-controlled entities (collectively, institutional investors). The Canadian Venture Capital Association (CVCA) reports that for the first three quarters of 2022, of the top ten most active PE investors in Canada, six were institutional investors (*CVCA: 2022 Canadian Private Equity Market Overview Year to Date Q3 2022*).

Canada's pension funds are among the largest global PE players, both through their investments in funds managed by others and their direct investment activity. According to Private Equity International's 2022 Global Investor 100 rankings (*Private Equity International: Global Investor 100 2022: The full ranking*), the Canada Pension Plan Investment Board (which invests Canadians' mandatory pension plan contributions) and the *Caisse de dépôt et placement du Québec*, a manager of funds for public and quasi-public organisations in Québec, are the first and third largest global PE investors, with USD130.5 billion and USD65.2 billion allocated to PE investments respectively. Three other Canadian pension fund managers are also listed in the top 30.

Institutional investors play an important role in venture capital (VC). However, private independent firms are also significant, and represented five of the top ten most active players in the Canadian VC space in the first three quarters of 2022, according to the CVCA (*CVCA: 2022 Canadian Venture Capital Market Overview Year to Date Q3 2022*).

Fundraising

Commitments for Canadian buyout and related funds reached CAD20.6 billion (raised by 22 funds) in the first nine months of 2022, down 18% from the same period in 2021. By contrast, Canadian VC fundraising, at CAD4.4 billion in commitments in the first nine months 2022, increased by 7% on the same period in 2021 (*Refinitiv: Canada Private Equity Buyout Review, First Nine Months 2022*; *Refinitiv: Canada Venture Capital Review, First Nine Months 2022*).

Investment

PE deal activity in Canada has cooled significantly following record levels in 2021. Refinitiv reports CAD12.2 billion across 361 Canadian buyout and related investment transactions in the first nine months of 2022, representing 65% and 35% year-on-year decreases in values and volumes, respectively (*Refinitiv: Canada Private Equity Buyout Review, First Nine Months 2022*). The CVCA reports CAD6.5 billion (less than half the five-year average) PE investment activity in Canada during the first nine months of 2022, but observes that deal volumes are only slightly down from 2021 and still well above the five-year average (*CVCA: 2022 Canadian Private Equity Market Overview YTD Q3 2022*).

With deal volume having dropped far less than deal value, it is reasonable to conclude that investors have taken a cautious approach in the face of macro-economic uncertainties and have been forced to adapt to tightening credit markets and rising interest rates.

Despite these economic headwinds and the overall slowdown in PE capital invested, demand for PE investment opportunities remains strong, partly due to continuing high levels of committed, but unallocated, capital. Auctions for Canadian targets in most sectors therefore remain competitive (although they tend to be less competitive than auctions for US targets, typically with fewer potential investors).

According to the CVCA, in the first nine months of 2022, the leading sectors for PE investment by value were:

- Business products and services, with over CAD1.5 billion invested across 49 deals.
- Information and communications technology, with over CAD1.4 billion invested across 107 deals.
- Industrial and manufacturing, with over CAD1.2 billion invested across 139 deals.

In terms of geographic breakdown, the CVCA reported that, in the first nine months of 2022:

- Québec led, with CAD3.7 billion in value across 342 deals.
- Ontario ranked second, with CAD2 billion across 142 deals.
- British Columbia ranked third for volume, with CAD197 million across 88 deals, and Alberta for value, with CAD482 million across 27 deals.

Typically, Ontario, Québec, British Columbia, and Alberta are the most active provinces for PE transactions.

After a record first quarter, VC investment levels in Canada for the second and third quarters of 2022 were, according to the CVCA, similarly down from 2021 levels but, at CAD7.2 billion and 520 deals across the three quarters, 2022 appears set to come in at or above the five-year average, with the slowdown in Q2 and Q3 perhaps representing a return to normal activity levels after the pandemic supercharged technology-related investment activity in particular (*CVCA: 2022 Canadian Venture Capital Market Overview Year to Date Q3 2022*).

Transactions

Buyouts and add-on investments, at CAD1.2 billion across 162 deals in the first nine months of 2022, represented 18% of all PE investment value for the period (*CVCA: 2022 Canadian Private Equity Market Overview Year to Date Q3 2022*). While this represents less than half of the deal value over the same period in 2021 and is also significantly below the five-year average, add-on activity in particular has seen relatively robust deal flow, possibly because the smaller deal sizes available are more attractive in the current market environment.

PE minority investments in the first nine months of 2022, at CAD2.8 billion across 162 deals, were also significantly below 2021 levels, but appear to be normalising with pre-pandemic levels (*CVCA: 2022 Canadian Private Equity Market Overview Year to Date Q3 2022*).

Exits

After a record-setting 2020 and a promising start to 2021, the Canadian initial public offering (IPO) exit market has disappeared altogether in 2022, with the CVCA reporting no IPO exits of PE-backed companies during the first three quarters. By contrast, mergers and acquisitions (M&A) exits have remained strong, with CAD 3.2 billion across 79 exits (representing the most robust M&A exit markets since 2018). Secondary buyouts, with CAD1.9 billion in exits across 17 transactions, have remained almost flat with 2021 (*CVCA: 2022 Canadian Private Equity Market Overview Year to Date Q3 2022*).

Similarly, Refinitiv reports that aggregate Canadian PE exits in the first nine months of 2022 came in at 43 exits and CAD 8 billion in deal value, representing a decrease of 47% and 67%, respectively, over the same period in 2021 (*Refinitiv: Canada Private Equity Buyout Review, First Nine Months 2022*).

2. What are the key differences between private equity and venture capital?

VC funds typically invest in minority positions in earlier stage growth companies, often with convertible preferred share structures similar to those favoured by US VC funds, whereas PE funds provide larger growth equity investments to more mature businesses or invest in change of control/buyout transactions. Funds of funds, distressed funds, mezzanine debt funds, and other private debt funds are also active in Canada.

Funding Sources

3. How do private equity funds typically obtain their funding?

The principal sources of funding for PE and VC funds in Canada are:

- Pension funds.
- Funds of funds.
- Banks and other financial institutions.
- Family offices and high net-worth individuals.
- University and other endowments.
- Sovereign wealth funds.

Tax Incentive Schemes

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

The Income Tax Act (ITA) contains the concept of Canadian-controlled private corporation (CCPC). CCPCs receive preferential tax treatment such as:

- A lower effective tax rate on their first CAD500,000 of net active business income.
- Better rates on the enhanced and refundable investment tax credit on all, or a portion, of the CCPC's qualified expenditure related to basic and applied research undertaken for the advancement of scientific knowledge and experimental development.

Individual shareholders in CCPCs can:

- Claim a potential capital gains exemption on the sale of shares of the CCPC where certain activities and asset tests are met and the shares have been held for at least two years.
- Claim the benefit of a tax deferral arising from the exercise of employment stock options granted by the corporation.
- More easily access preferential capital gains tax treatment on stock option benefits.

In general, to qualify as a CCPC, a corporation must be a Canadian private corporation that is not:

- Directly or indirectly controlled, or deemed to be controlled, by one or more non-resident persons or public corporations.
- A corporation that would, if each share owned by a non-resident person or a public corporation were owned by a single hypothetical person, be "controlled" by that hypothetical person.

Fund Structuring

5. What legal structure(s) are most commonly used as a vehicle for private equity funds?

Most PE and VC funds established in Canada are set up as limited partnerships, with investors becoming limited partners and a newly created corporation controlled by the fund manager being the general partner. This structure is common for such funds because:

- Losses and gains flow through to partners (see *Question 6*).
- Liability of the limited partners is generally limited to the amount of capital contributed or agreed to be contributed, provided generally that they are not involved in the management of the business of the partnership (although participation on advisory committees is permitted). (The general partner has unlimited liability.)

6.Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

For Canadian federal and provincial income tax purposes, a limited partnership is generally not taxed as a separate entity and is considered a flow-through vehicle (that is, income or losses are passed through to its partners). However, the partnership must calculate its income and losses from various sources. Each partner must then recognise the appropriate share of the income and loss components in its own Canadian and provincial tax return.

A limited partnership can be subject to Canadian withholding tax if it has any partners that are non-residents of Canada (see *Question 14, Taxes*). To manage compliance with tax laws, most PE and some VC funds set up parallel funds for non-resident investors.

7. What foreign private equity structures are tax-inefficient in your jurisdiction? What alternative structures are typically used in these circumstances?

Many US PE funds are structured as limited liability companies (LLCs) and, therefore, are flow-through vehicles for US income tax purposes. Due to anti-hybrid rules in the Canada-US Tax Treaty, LLCs may be tax-inefficient where flow-through treatment of the Canadian operating income of the portfolio entity, or access to a reduced withholding rate on passive income, is desired. To achieve this treatment, it is generally preferable to structure the fund as a limited partnership, as this is regarded as a flow-through structure for Canadian as well as US tax purposes.

Several tax-efficient structures have been developed to accommodate structures commonly used by foreign PE funds that invest in Canada, including where the transaction uses leveraged financing arrangements. These include:

- The "conventional" structure, involving the incorporation of a Canadian acquisition company that is then amalgamated with the target.
- A variation of the "conventional" structure using hybrid debt.
- Structures involving Luxembourg or other foreign entities.

Certain structures of this nature are becoming increasingly difficult to implement due to the Organisation for Economic Co-operation and Development's base erosion and profit shifting initiatives, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, and related changes in domestic taxation.

Fund Duration and Investment Objectives

8. What is the average duration of a private equity fund? What are the most common investment objectives of private equity funds?

Duration

The average duration of a PE fund is seven to ten years, with rights to extend the term by two years. However, direct PE investments by pension funds can have a longer time horizon, and privately managed PE funds, including family offices, with longer investment terms or evergreen structures, have begun to emerge.

Typically, capital is called and invested within the first three to six years following the closing of the fund, depending on the underlying asset class. The investments are then divested and net proceeds distributed. The actual duration of a fund depends on the fund type and on the state of the market during the investment and exit periods.

Investment Objectives

The objective of PE funds is to make capital gains and return net proceeds to investors by investing in existing businesses and providing fund managers with profits above determined rates of return. Some funds focus on a specific industry (although Canadian PE firms tend to be more generalist), while others focus on a certain risk profile, such as distressed funds.

Many Canadian PE funds have also adopted environmental, social, and governance (ESG) objectives, which factor into their strategies and investment decisions.

The PE and VC investment funds associated with Canadian and provincial governments also often have regional or industry-specific development objectives.

Fund Regulation and Licensing

9. Do a private equity fund's promoter, principals and manager require authorisation or other licences?

National Instrument (NI) 31-103 harmonises registration requirements and exemptions throughout Canada. The basic principles are that, unless otherwise exempt:

- A person in the business of trading in securities must register as a dealer.
- A person in the business of advising others on investing in, or buying or selling securities, must register as an adviser.
- A person acting as an investment fund manager (that is, who directs the business, operations, or affairs of an investment fund) must register as an investment fund manager.

Depending on the facts, a person or firm may be required to register under more than one category, unless an exemption is available.

Often (to the extent the fund manager or the fund do not engage in other activities that would require registration), a PE or VC fund manager (or, as applicable, the fund) need not register as:

- An adviser, provided that the advice given in connection with the purchase and sale of companies is incidental to its active management of companies it invests in.
- A dealer, provided that the raising of money from investors and its subsequent investment are occasional and uncompensated activities.
- An investment fund manager, provided that the fund manager is actively involved in the management of the companies it invests in, or the PE or VC fund otherwise invests in the underlying portfolio companies for the purposes of achieving control.

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

Regulation

The concept of "investment companies" does not exist under Canadian law.

However, when offering interests in a fund, PE and VC firms must comply with prospectus and dealer registration requirements under securities laws, unless they can avail themselves of exemptions.

Exemptions

PE and VC funds generally seek to rely on the following exemptions from certain securities regulatory requirements:

- Offers and sales to "accredited investors" as defined in NI 45-106. Accredited investors are considered sophisticated buyers, and include:
  - financial institutions;
  - the government and its agencies;
  - pension and investment funds: and
  - certain high net-worth individuals.
- To the extent possible, the narrower subset of "permitted clients." Most institutional investors also qualify under the more stringent "permitted client" category set out in NI 31-103, but this category includes higher thresholds for high net-worth individuals.

The benefit of relying on the accredited investor exemption is that the issuer is not required to deliver a prospectus to investors in connection with the offering.

Restricting an offering to permitted clients generally means a lighter level of onboarding compliance and documentation.

11. Are there any restrictions on investors in private equity funds?

There are no general restrictions on investor eligibility to invest in a PE fund. However, PE funds typically restrict offers and sales to certain types of investors, which allows them to benefit from the prospectus exemption from the prospectus requirements (see *Question 10*).

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

There are no general statutory investment periods or investment amounts.

Any resale of fund interests generally needs to rely on a subsequent prospectus exemption, which is often the same as, but may be different from, the original prospectus exemption.

Additionally, the limited partnership agreement usually provides that the interests in the PE fund cannot be transferred without the general partner's prior approval.

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

The limited partnership agreement and subscription agreement govern the relationship between the fund and the investors. The terms are negotiated by the PE or VC fund and potential "anchor" limited partners (that is, the first key significant investors).

The partnership agreement can include the following terms to protect the fund and its investors:

- Term of the fund.
- Details of capital calls and commitments.
- Investment restrictions, including:
    - fund size;
    - asset concentration limits;
    - relative position minimums;
    - borrowing limits; and
    - geographic or investment type limits.

- Co-investment rights.
- Creation of parallel funds.
- Compensation to the general partner (for example, carried interest and management fees).
- Expenses borne by the partnership, including caps and how broken deals are dealt with.
- Advisory committee and its role on matters such as mark-ups and mark-downs of investments, valuations, conflicts of interest, and defaults.
- Reporting obligations to investors.
- Removal and replacement of general partners.
- Transfer restrictions imposed on limited partners.
- Confidentiality provisions.
- Key person provisions, including rights relating to key person departures (such as prohibitions on further capital calls or termination of the fund).

Many limited partnership agreements also allow the general partner to enter into side letters with limited partners, often for the purpose of addressing special arrangements with certain limited partners, or to deal with issues that are specific to that limited partner or subset of limited partners. These side letters often include most favoured nation treatment, as well as anti-money laundering and pension regulatory restrictions.

Where an offering memorandum providing details about the fund is prepared, it may be necessary, or advisable, to incorporate certain Canada-specific notices, disclaimers, or representations. A misrepresentation in the offering memorandum may result in statutory liability and rights of action (including rescission rights) under Canadian securities laws.

Many of Canada's largest LP investors are members of the Institutional Limited Partners Association, which publishes industry best practices and various model documents for PE funds.

Interests in Portfolio Companies

14. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

Most Common Form

In the case of a buyout, the most common forms of interest are:

- Common shares that typically convey the right to vote, receive dividends, and participate on liquidation, dissolution, or winding-up.
- Debt (primarily financed by banks).

In the case of the acquisition of a minority interest, including in VC transactions, the most common forms are those detailed above, and also:

- Convertible preferred shares (which are the most common form of investment for VC funds), as their attributes can be tailored to include a preference on dividends, participation in the case of liquidation or sale and voting, as well as conversion and redemption rights.
- Convertible secured subordinated debt, as its attributes can be tailored to include:
  - a priority over all equity and most unsecured creditors in a bankruptcy or insolvency scenario;
  - payments of interest, which, unlike dividends, are not subject to solvency restrictions; and
  - the right to convert into equity with a protected conversion price.
- Warrants, which are options to acquire common shares, convertible preferred shares, or other securities, typically used as consideration in debt financings.

Debt levels vary based on the business objectives of the fund structuring the investment, but generally tend to be lower for Canadian PE funds than their US competitors, and significant levels of leverage are not common for most Canadian VC-backed portfolio companies.

Other Forms

Performance warrants (options to acquire common shares, which vest based on certain milestones) are less commonly used, but can be used to bridge valuation gaps or as an alternative to convertible preferred shares when these are not desirable from a Canadian tax perspective (see *below*, *Taxes*).

A domestic or foreign limited partnership structure may be used at or above the operating entity level when there is a desire to implement a waterfall-type allocation between investors and a management team or subsequent rounds of investors.

Restrictions

Applicable Canadian corporate statutes contain restrictions on share issues in certain circumstances. For example, in most Canadian jurisdictions, a share cannot be issued until the consideration for the share is fully paid. In addition, to benefit from exemptions from the prospectus requirements, share issues must comply with the relevant securities law provisions (see *Question 10*).

The articles of incorporation or applicable shareholders' agreements usually contain restrictions on the transfer of shares in private companies.

Taxes

The following taxes generally apply to equity financing:

- Dividends paid by Canadian corporations to non-resident shareholders are subject to withholding tax at a rate of 25%, which may be reduced by a tax treaty. A return of the amount invested in the corporation (that is, paid-up capital) is not subject to withholding tax.
- Non-residents of Canada are subject to Canadian tax on capital gains from the disposition of "taxable Canadian property" (TCP), subject to tax treaty exemptions. However, equity interests in a Canadian business that do not principally derive (or have not in the past 60 months principally derived) their value from Canadian real or immovable property, Canadian resource property, timber resource property or options in respect of these properties, are not TCP, and therefore are not subject to Canadian taxation on disposition.
- Preferred shares issued by private Canadian companies, depending on their terms, may be subject to the ITA's complex "taxable preferred shares" rules, which can cause unexpected tax liabilities for the investee company and be particularly problematic for companies that are not otherwise paying cash taxes. These rules can, in certain circumstances, make US VC-style convertible preferred shares an undesirable structure for investing in Canadian companies.

Generally, the following taxes apply to debt financing:

- Interest paid to non-resident investors who do not deal at arm's length with the payer is subject to a 25% non-resident withholding tax, which can be reduced by a tax treaty.
- Interest paid by a Canadian corporation to a non-resident is generally deductible in Canada, subject to the thin capitalisation rules and transfer pricing rules:
  - the thin capitalisation rules provide that where the debt (owed to significant non-resident shareholders and certain related persons) to equity ratio exceeds 1.5:1, a Canadian corporation cannot deduct interest in respect of the excessive debt, and interest payments on the excessive debt are treated as dividends (similar rules exist for other entities); and
  - the transfer pricing rules require that interest paid by a Canadian corporation to a non-arm's length non-resident person reflect an arm's length rate of interest.
- Additional interest deductibility limitations were originally announced as part of the 19 April 2021 Canadian federal budget and revised as part of the 3 November 2022 Fall Economic Statement. These limit interest deductions to a maximum of 40% of earnings before interest, taxes, depreciation, and amortisation (EBITDA) (for years beginning on or after 1 October 2023) and 30% of EBITDA (for taxation years following that).

Buyouts

15. Is it common for buyouts of private companies to take place by auction? Which legislation and rules apply?

Auctions are common in the Canadian PE market. There are no particular legislative requirements specific to auction processes, but as with any other transaction, general securities and corporate laws apply, as may other specific laws (for example, where the parties are in the same or related industries, anti-trust issues may need to be addressed).

The auction process rules are usually set by the seller and its legal and financial advisers, who manage the process. Where the auction is in a bankruptcy or an insolvency context, the receiver or monitor, as applicable, is involved in the process, and court approval is required.

16. Are buyouts of listed companies (public-to-private transactions) common? Which legislation and rules apply?

Buyouts

Public-to-private transactions are common, and generally implemented through a plan of arrangement (similar to a US merger) or, less frequently, a takeover bid (tender offer). Corporate statutes, securities laws, and the rules of the stock exchange on which the target is listed apply to these transactions.

A plan of arrangement is a court-sanctioned procedure under the applicable Canadian corporate statute. It can be used in a leveraged buyout, as financing can be approved by the court.

Shareholders must approve any arrangement, but the court sets out the terms under which the shareholders' meeting proceeds and the threshold for approval, which is usually two-thirds of the votes cast and often divided by classes of shareholders.

Dissent and appraisal rights are usually part of the court-mandated process. Final approval of the court at what is typically referred to as the "fairness hearing" is necessary, and is granted following the requisite shareholder approval and a finding that the arrangement is "fair and reasonable."

Many rules dealing with the substantive and procedural bid requirements of takeover bids have been harmonised between most Canadian local jurisdictions by the Canadian Securities Administrators. Generally, takeover bids must remain open for 105 days and are subject to minimum tender conditions. Adequate financing arrangements must be in place at the time of the bid, making a takeover bid unattractive in a leveraged buyout. Canadian corporate statutes generally provide that:

- Where enough shares are tendered to bring the bidder's interest to 90% or more, a statutory compulsory acquisition procedure is available to acquire the remaining shares, subject to dissent and appraisal rights.
- Where enough shares are tendered to the bid to bring the bidder's interest to, usually, the two-thirds level, a second-step squeeze-out is usually possible, conditional on "majority of minority" support and subject to dissent and appraisal rights.

Private Investments in Public Equity (PIPE) Transactions

PIPE transactions by Canadian PE funds are not uncommon, but these investments are generally limited to non-controlling interests.

Principal Documentation

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

Acquisition of a Private Company

In a private target buyout, the principal document is usually a share purchase or an asset purchase agreement, depending on a number of considerations, including those relating to:

- Liability allocation.
- Consents
- Tax.
- Assets targeted (in the case of a carve-out sale).

Arrangement agreements or amalgamation agreements are less common in private transactions but are used in certain cases, such as where there are multiple shareholders and concerns about obtaining their consent.

Ancillary documents commonly include:

- An escrow agreement.
- Restrictive covenant agreements.
- Employment agreements.
- A shareholders' agreement.
- Representation and warranty insurance (RWI).

In debt financed private buyouts, there are also:

- Debt financing commitment letters.
- Credit agreements.
- Security agreements.

In certain cases where there is a separate signing and closing, sellers may also ask for an equity commitment letter or a limited guarantee from the fund sponsor.

In private target buyouts, the transaction documents generally remain private and confidential, so long as none of the parties to the transaction is a public company that is required to file the transactions documents.

Acquisition of a Listed Company

In a public target buyout, the principal documents are:

- For a plan of arrangement, an arrangement agreement and a management proxy circular.
- For a takeover bid, a support agreement with the target (assuming the transaction is not hostile), a takeover bid circular, and a directors' circular.

Ancillary documents almost always include lock-up or voting agreements with the principal shareholder or other shareholders of the target. All these documents are generally publicly filed and accessible on the System for Electronic Document Analysis and Retrieval (SEDAR), run by the Canadian Securities Administrators.

Buyer Protection

18. What forms of contractual buyer protection do private equity funds commonly request from sellers and/ or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

Buyer protections from sellers in a private target acquisition generally include:

- Post-closing purchase price true-up provisions.
- Representations and warranties.
- Interim covenants.
- Closing conditions.
- Termination rights.
- Post-closing indemnification or RWI.

The indemnification obligations, with some exceptions, are subject to:

- Survival periods.

- Caps on liability.
- Baskets or deductibles setting out the minimum dollar amount of losses that must be suffered under the agreement before a party is obliged to indemnify the other.

The indemnification obligations can be secured by an escrow (often a sole remedy escrow for general representations and warranties in PE transactions) and are often backed up by RWI. Sellers are also asked to give non-competition and non-solicitation covenants.

RWI has become a ubiquitous feature of Canadian private M&A transactions, particularly when a PE fund or portfolio company is a party to a buyout or sale transaction. It has also begun to be used in PE minority investment transactions. In certain transactions, buyers agree to a "no-indemnity" contract and rely exclusively on RWI.

Buyer protections from sellers in a public target acquisition include all the provisions discussed above, except for:

- Post-closing purchase price true-up provisions.
- Post-closing indemnification obligations and related matters.

Public target acquisitions usually have higher materiality qualifiers than private target acquisitions for representations and warranties, interim operating covenants and closing conditions. They also include:

- Additional conditions regarding the sufficiency of the number of shareholders agreeing to the transaction, as well as dissent rights.
- Provisions dealing with the fiduciary duties of the target's board and related break fees payable to the buyer, and reverse break fees payable to the public target most often in relation to regulatory matters.

Although RWI remains mostly used in private transactions, it is sometimes considered and used in public deals.

In most transactions, there are no separate protections obtained from the target's management team. They may owe obligations as sellers, employees, directors or officers.

In minority investment transactions involving preferred shares or convertible debt in both the PE and VC context, anti-dilution protections are typically included. These can include corporate structural anti-dilution adjustments (generally on a weighted-average basis) and price protection features, or investors may be able to protect themselves from dilution by negotiating pre-emptive rights or veto rights in respect of future financing rounds.

The CVCA publishes a set of model VC investment documents based on the National Venture Capital Association's model US VC documents. These CVCA models are often used as a reference in negotiating certain kinds of VC transactions in Canada.

It is fairly uncommon for investors to have the right to put their investment back to the sellers.

19. What non-contractual duties do the portfolio company managers owe and to whom?

Under Canadian corporate statutes, directors and officers of a corporation owe a duty of loyalty and a duty of care.

The duty of loyalty is owed to the corporation, even if the person is nominated by a particular shareholder. It requires directors and officers to act honestly and in good faith with a view to the best interests of the corporation, and includes the obligation to:

- Maintain confidential information they acquire by virtue of their position.
- Avoid all possible conflicts of interest with the corporation.
- In the case of any conflict, disclose the matter and abstain from related deliberations.

Directors and officers are subject to the corporate opportunity doctrine, which restricts them from taking business opportunities that belong to the corporation. Only one provincial corporate statute in Canada explicitly permits waivers of the corporate opportunity doctrine, although such waivers are often included in unanimous shareholders' agreements across Canadian jurisdictions.

The duty of care requires that directors exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances. It is owed to the corporation and, depending on the corporate statute, to other stakeholders.

Employment laws also impose duties, such as the duty of loyalty.

Going-private transactions with management participation may also be subject to enhanced disclosure obligations, minority approval requirements or formal valuation requirements under applicable securities laws, and typically require the formation of an independent committee of the board of directors that will be tasked with evaluating and negotiating the proposed transaction.

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

The typical employment terms imposed on management include:

- Term.
- Compensation package.
- Benefits.
- Termination and severance.
- Confidentiality and non-competition.

Canadian employment law does not recognise the concept of "employment at will"; a contractual employer-employee relationship is implied by law whether or not a written agreement exists. Canadian employment legislation sets out minimum standards of employment applicable to all employees, including the length of notice and severance payable on termination.

Non-competition and non-solicitation covenants are also often imposed on management. To be enforceable, these post-employment covenants must be clearly drafted, limited and reasonable as to their duration, territory and activities covered to that which is necessary to protect the employer's legitimate business interests. The courts usually interpret these covenants restrictively, which is favourable to employees. The courts do not generally apply the blue pencil rule (that is, reducing the scope of an otherwise unenforceable clause, to allow for its enforcement) in the employment agreement context. In addition, in 2021, Ontario passed legislation prohibiting employee non-competition agreements in that province, other than for a chief executive officer in the context of a sale of business.

Non-competition agreements granted by an employee who is also a selling shareholder in the context of the sale of a business are more readily enforced by Canadian courts, provided that the employee receives sufficient consideration to justify this protection and the restrictions are limited to what is necessary for the protection of the legitimate interests of the party in whose favour it is granted.

There may be additional terms relating to employment, including:

- Restrictive covenants.
- Option agreements.
- Shareholders' agreements.

However, new terms cannot be imposed in an employment contract without providing new consideration, so restructuring employment terms in the context of a buyout can be challenging in respect of employees who are not also shareholders.

21. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

In buyouts, the PE sponsor owns the majority of the voting shares of the company and management owns a minority interest. Typically, the PE sponsor and management shareholders enter into a shareholders' agreement providing:

- The sponsor with the right to elect a majority of the board.
- Pre-emptive rights procedures and transfer restrictions.
- Measures to deal with the shares of management shareholders who leave the employment of the corporation.
- Veto or other decision-making rights for the sponsor in respect of change of control transactions.

A separate registration rights agreement can set out the shareholders' rights in connection with public offerings. These agreements are less common in Canada than the US, likely due to the statutory hold periods and resale restrictions being less stringent in Canada; however, they are still often used by Canadian companies, particularly when US investors are involved.

In minority investment transactions, in both the PE and VC context, shareholders' agreements often address a more complex set of concerns, including:

- Director nomination and board observer rights.
- Investor vetoes or supermajority approval requirements in respect of certain governance matters.
- Conflicts of interest and corporate opportunities.
- Rights and obligations in respect of future financing rounds.
- Measures to deal with transfers of shares by investors and management (often including rights of first refusal, tag-along rights, or piggyback rights, as well as certain permitted transfers).
- The ability to force a liquidity event in certain circumstances, sometimes subject to a specified threshold of investor returns being achieved (such as a multiple on invested capital).

These provisions are more likely to be found in a unanimous shareholder agreement (USA) for a Canadian corporation than in its articles or bye-laws. Subject to respecting certain formalities, in most Canadian jurisdictions, a USA constitutes a governing document of the corporation, and is binding on both current and future shareholders. However, British Columbia is an exception as its corporate statute does not include the USA concept, so in that jurisdiction certain provisions usually included in USAs in other Canadian jurisdictions are instead included in a corporation's articles.

In respect of director nomination rights, Canadian federally incorporated corporations, and also corporations incorporated under certain provincial statutes, must have at least 25% Canadian-resident board members.

Debt Financing

22. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

Typically, PE transactions are financed by a combination of debt and equity. The amount of debt provided by a foreign buyer depends in part on interest deductibility under the thin capitalisation rules, transfer pricing rules and the additional budget measures announced on 19 April 2021 (and revised on 3 November 2022) (see *Question 14*, *Taxes*). Other factors influencing the percentage of debt are the size of the transaction and the state of the lending market.

The type of debt used to finance a PE transaction depends on where the lender stands in order of priority to other lenders, if any. In respect of senior debt, traditional term loans provided by banks are often used, but private debt funds and direct institutional investor participation have been taking an increasing share of Canadian private debt markets. Mezzanine debt also plays an important role in PE transactions in Canada.

Lender Protection

23. What forms of protection do debt providers typically use to protect their investments?

Security

Debt providers typically protect their investments by taking security over the borrower's assets and secured guarantees from the borrower's affiliates. The borrower's corporate structure, including the borrowing needs of any subsidiary, affect the parties' requirements and the documentation.

All provinces and territories in Canada (except Québec) have Personal Property Security Act legislation modelled on Article 9 of the US Uniform Commercial Code. A security interest can be granted over all personal property, whether existing or subsequently acquired. Lenders obtain security over real property through mortgages that are registered against the title to the real property in the applicable provincial land registry.

In Québec, the rules and priorities are set out in the Civil Code of Québec. The principal form of security in Québec is the hypothec, which can be granted to secure any obligation and creates a charge on personal (movable) or real (immovable) property, present or future.

Most Canadian provinces have central registries and comparable priority rules. Securities, including shares, can be pledged in Canadian jurisdictions.

Contractual and Structural Mechanisms

In situations involving multiple debt providers, the parties can enter into subordination or inter-creditor agreements, which seek to govern the relative priorities of claims and voting rights of lien holders in the event of insolvency.

Financial Assistance

24. 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 affect the ability of a target company in a buyout to give security to lenders? Are there any exemptions?

Rules

Financial assistance provisions have been repealed in the most commonly used Canadian corporate statutes (including in the federal statute), but some of these statutes still require that a statutory solvency test be satisfied for a corporation to give financial assistance to related parties or impose certain disclosure requirements. In entering into financial assistance transactions, directors must also be aware of their fiduciary duties (see *Question 19*), as imprudent financial assistance transactions may lead to director liability.

Exemptions

The provincial statutes generally include exemptions for financial assistance provided by a wholly-owned subsidiary to its parent, or by a parent to its wholly-owned subsidiary.

Insolvent Liquidation

25. What is the order of priority on insolvent liquidation?

Two federal statutes primarily govern insolvency and restructuring proceedings of corporate debtors:

- The Companies' Creditors Arrangement Act (CCAA), which only applies to insolvent companies with debt in excess of CAD5 million.
- The Bankruptcy and Insolvency Act (BIA).

The general rule is that debts are ranked equally within each class of creditors in a bankruptcy or insolvency, and if the assets are insufficient to meet them in full, they are paid on an equal footing. However, there are numerous exceptions to the general rule.

The general scheme of distribution in bankruptcy liquidations is as follows (this also applies to a large extent to insolvency restructurings or liquidations in general, but with some variations depending on the structure adopted:

- **Super-priority claims.** The BIA, as well as other statutes, establishes certain super-priority claims that rank ahead of all other claims in a bankruptcy. These include (but are not limited to):
  - workers, to a maximum of CAD2,000 per employee, for unpaid wages earned up to six months before the appointment of a receiver or initial bankruptcy event;
  - amounts deducted and not remitted, and for unpaid regularly scheduled contributions to a pension plan; and
  - claims made by unpaid suppliers for the return of goods supplied to the debtor company in the 30-day period before bankruptcy (the super-priority attaches to the unpaid goods). To access this right, suppliers must send a written demand within 15 days of the purchaser becoming bankrupt or a receiver being appointed. Goods can only be repossessed if they are identifiable, in the same state as they were on delivery, still in the trustee's possession, and not subject to an arm's-length sale.
- **Secured creditors.** Various types of secured creditors rank differently in this hierarchy depending on the nature of the debt and assets. Although this class generally operates outside a bankruptcy under the BIA, their claims are charged only after super-priority claims (see above).
- **Preferred claims.** These are paid in roughly the following order:
  - the costs of administration of the bankruptcy;

    - a levy in favour of the Superintendent of Bankruptcy (about 5% on the first CAD1 million of distributions, and a sliding scale on amounts in excess of CAD1 million);
    - certain additional claims of wage-earners for arrears of wages;
    - certain remaining claims of secured creditors;
    - municipal taxes assessed or levied against the bankrupt, within the two years immediately preceding the bankruptcy, that do not constitute a secured claim (see above);
    - landlord claims for rent for a period of three months preceding the date of bankruptcy and for accelerated rent for a period not exceeding three months following the date of bankruptcy if entitled to this under the lease (the total amount payable in priority cannot exceed the amount realised from the property on the leased premises);
    - claims of Workers' Compensation Boards and claims resulting from injuries to employees; and
    - claims of the federal and provincial governments not mentioned above.

- **Unsecured creditors.** Distributions can be made to unsecured creditors on an equal footing.
- **Claims proved in the bankruptcy.** If there is any surplus after payment in full to the unsecured creditors, the balance is used to pay interest at 5% per year on all claims proved in the bankruptcy according to their priority.
- **Shareholders.** Any remaining amount is then available to the shareholders (who have no priority during the bankruptcy process due to having no claims against any assets of the defaulting party).

Equity Appreciation

26. Can a debt holder achieve equity appreciation through conversion features such as rights, warrants or options?

A debt holder can achieve equity appreciation value if they hold convertible debt securities or through other convertible securities, such as warrants.

Portfolio Company Management

27. What management incentives are most commonly used to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

The most commonly used management incentives to maximise income returns and facilitate a successful exit in respect of both PE and VC portfolio companies include both non-equity-based incentive plans (for example, cash bonuses) and equity incentive plans. The adoption and implementation of such plans by private companies is not subject to any specific regulatory authority approvals or oversight.

The most commonly used equity incentive plan is a stock option plan, due to the tax advantages it can offer (see *Question 28*). Other types of stock-based compensation (for example, restricted stock and profit interests) are not as prevalent in Canada, as they may not provide similar tax benefits and may even result in undesirable tax consequences for management.

Stock option plans typically include provisions regarding the treatment of options on a change of control of the issuer, but these vary widely. For example, they can provide for:

- Conversion to options of the acquiring company.
- Acceleration of vesting.
- Early termination.
- Required exercise of vested options and sale of the underlying shares during the transaction.

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

Properly structured stock options can offer significant tax incentives to management, including:

- A deferral advantage because, in general, the taxable event for management and the company is (at the earliest) the time when the manager exercises the option, and not the time at which the option is granted. If the granting company is a Canadian-controlled private corporation, a further deferral may be available until the time at which the manager disposes of the shares underlying the option.
- Taxation that is similar in effect to capital gains treatment. In general, the difference between the exercise price of the option and the fair market value of the share when the option is exercised is considered to be employment income for the manager. However, provided certain conditions are met, the manager is entitled to a deduction in calculating their taxable income equal to one-half of that amount (although a manager who is a resident of Québec at the end of a taxation year is generally only entitled to a deduction of one-quarter of the amount). However, recent amendments have been made to this regime, which may make stock options less attractive for certain companies (see *Question 33*).

29. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

Canadian corporate statutes generally prohibit corporations from declaring or paying a dividend, purchasing or redeeming their own shares, or reducing their stated capital if there are reasonable grounds to believe that either:

- A corporation is unable to pay its liabilities as they become due (or would be, after making the payment).
- In all cases, other than redemptions and certain purchases, the realisable value of the corporation's assets would be less than the aggregate of its liabilities and the stated capital for all classes of shares. In the case of redemptions and certain purchases, the realisable value of the corporation's assets is compared to the aggregate of the corporation's liabilities and the amount that would be required to be paid to the holders of shares who have a right to be paid on a redemption or liquidation before the holders of the shares to be purchased or redeemed.

Canadian corporate statutes generally prohibit priorities on dividends between different series within the same class of shares.

It is an indictable offence to charge interest in excess of 60% (interest is broadly defined, and includes interest, fees, charges, and expenses) (Criminal Code). As a precaution, most agreements include a provision reducing the interest retroactively to the maximum amount or interest rate allowed by law. The Interest Act (Canada) also contains other restrictions that may apply under certain circumstances.

30. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

Protections

Investment documents typically include anti-corruption and anti-bribery protections, such as representations and warranties on compliance with anti-corruption and anti-bribery laws that cover applicable Canadian and foreign laws.

The Criminal Code establishes the following as criminal offences:

- Bribery (or attempted bribery, or aiding and abetting such crimes) of public officials (including executives of state-owned enterprises).
- Payment of "secret commissions" (bribes paid secretly to employees of any business).

In addition, there are two relevant federal statutes that deal with anti-corruption or anti-bribery of officials in foreign countries, and both apply to individuals and entities:

- The Corruption of Foreign Public Officials Act (CFPOA), which makes bribery and corrupt practices in foreign countries a crime in Canada, whether direct, or through an agent or a third party.
- The Freezing Assets of Corrupt Foreign Officials Act (FACFOA), which deals with misappropriated property of foreign states, and provides that on the request of a foreign state, the Government of Canada can order the freezing of such property.

Penalties

The following penalties apply:

- Convictions for offences under the Criminal Code can lead to a term of imprisonment or unlimited fines.
- Conviction for offences under the CFPOA can lead to a term of imprisonment, or unlimited fines.
- Convictions for offences under FACFOA carry:
  - for summary offences, a maximum fine of CAD25,000 or a maximum one-year term of imprisonment; and
  - for indictable offences, longer terms of imprisonment.

In addition to the penalties under criminal and other legislation, companies and individuals convicted of, or in some cases charged with, certain "integrity"-related offences under a variety of legislation, are barred from doing business with the federal and certain provincial governments. Affiliates may also be barred in some circumstances.

Canadian entities operating in the oil, gas, or mineral exploration and extraction sectors must also comply with the Extractive Sector Transparency Measures Act (ESTMA), which requires companies to file public annual reports disclosing certain types of payments, including any payments to a single government, foreign or domestic, in excess of CAD100,000 a year. Subject to a due diligence defence, failure to comply with the disclosure obligations under ESTMA carries potential fines of up to CAD250,000 for both entities and for individuals (including those who do not actively participate in the breach but merely acquiesce), and fines can be charged separately for each day on which the breach occurs or continues.

Exit Strategies

31. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of Exit

The forms of exit typically used to realise a PE or VC fund's investment in a successful company are:

- Full or partial private sale to a third party.
- Initial Public Offering (IPO).
- Merger or other business combination with a special purpose acquisition company.

Advantages and Disadvantages

In recent years, a private sale to a third party (whether to another company or to a PE buyer) has been the most common option. An important advantage is that it can provide a complete exit on a confidential and exclusive basis. However, its disadvantages include:

- Post-closing indemnification obligations of the seller, which may hinder the ability to return funds back to the investors, although this issue has been tempered by the use of RWI (see *Question 18*).
- Potential regulatory review if there are anti-trust issues, or if the investment is being sold to a foreign investor.

A growth equity investment by a PE investor with different investment objectives can also sometimes offer liquidity to earlier stage investment funds.

An IPO can offer a substantially higher return on investment for a PE sponsor in the right market conditions. However, finding the right market window to exit through an IPO can be challenging. As discussed in *Question 1*, the IPO market in Canada was resurgent in 2020 and early 2021, but is currently not an immediate option for most exits. Additionally, an IPO does not usually offer an 100% immediate exit for a significant investor. Regulators, underwriters, and prospective investors have requirements as to how much of the IPO can be made up of existing stock to pay out departing shareholders, and of new stock to finance the corporation itself.

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

Forms of Exit

In Canada, there are four processes through which a financially distressed business (whether backed by PE or VC funds, or otherwise) can be sold to a purchaser or restructured with the participation of a new investor:

- Proceedings under the CCAA.
- Proposal process under the BIA.
- Receivership under the BIA.

- Bankruptcy liquidation under the BIA.

Both the CCAA arrangement and the BIA proposal are debtor-in-possession processes that allow for the sale or reorganisation of a business as a going concern, while the debtor continues to operate under the protection, supervision, and control of the court. The CCAA arrangement process is more flexible, discretionary, and judicially driven (but, as discussed above, applies to insolvent companies with debt in excess of CAD5 million), while the BIA proposal process is leaner, more standardised and may be better suited for a smaller business. As such, the CCAA arrangement remains the statute of choice for the sale or restructuring of a larger business operation (although the BIA remains available for larger businesses as well).

A receivership under the BIA is also commonly used to liquidate property or facilitate the sale of a distressed business as a going concern. This remedy is triggered by a secured creditor and places the assets under the control of an appointed receiver who is empowered to take the following steps in relation to the insolvent debtor company's assets:

- Take possession.
- Manage on an interim basis.
- Ultimately sell.

Receivers can be appointed privately, by a secured party, or by court order. They derive their authority from the secured creditor's security documentation. Court-ordered receivers are appointed under federal or provincial legislation, where the federal legislation provides receivers with national jurisdiction. Court-ordered receiverships are typically initiated by an application by a secured party under the BIA. Private receiverships are far less common than court-appointed receiverships. Since a bankruptcy does not generally affect the rights of secured creditors, a receivership can occur at the same time as a bankruptcy.

A BIA bankruptcy does not involve the sale of the business as a going concern: rather, it leads to liquidation of the assets by a trustee. During a BIA bankruptcy proceeding, the trustee's primary duties are to:

- Collect, preserve, and sell the assets of the bankrupt, subject to the rights and actions of secured creditors.
- Distribute available proceeds to creditors in accordance with their prescribed priorities and pro rata within each class of creditors.

The trustee:

- Compiles certain statutory documents in accordance with the BIA.
- Notifies creditors of the debtor company's bankruptcy.
- Arranges for the first meeting of creditors to provide creditors with information on the bankruptcy.
- Investigates, where necessary, the affairs of the bankrupt, and any transactions entered into before bankruptcy.

At the end of the proceeding, the trustee is discharged, and the company is eventually be struck from the register of companies. The BIA bankruptcy provisions are essentially analogous to Chapter 7 of the US Bankruptcy Code, although there are a number of important technical differences.

Advantages and Disadvantages

The advantages and disadvantages of each scenario for effecting a sale or reorganisation depend on the circumstances, including the:

- Capital structure of the distressed business.
- Security held by its creditors.
- Nature of the business operations and assets.
- Identity and objectives of the party initiating the process.

Asset sales in the context of CCAA proceedings and BIA proposals or receiverships typically involve the implementation of a sales process under the supervision of a court-appointed officer.

Since distressed companies under court protection can be attractive targets for potential purchasers looking to acquire a business at a discount, this can be concurrently carried out with an investment solicitation process. The sales process is flexible, and is designed to maximise the value of the business assets, similar to a section 363 sale process under the US Bankruptcy Code. The court must authorise the sale; it issues an approval and vesting order that allows the purchaser to acquire the assets, free and clear of any liens and encumbrances. If the exit strategy relies on investor financing of a CCAA plan of arrangement or BIA proposal, this financing is typically conditional on approval of the plan or proposal by the creditors and the court, and on a corporate reorganisation of the debtor's capital structure.

A traditional approval and vesting order conveys the assets of the debtor corporation to a purchaser, leaving liabilities behind. In recent years, "reverse" vesting orders have been granted in CCAA proceedings, under which the debtor's liabilities are conveyed to a new "residual corporation," while the assets and any assumed liabilities remain in the debtor corporation. The debtor generally continues to operate as a going concern, with the support of new investors or investments. The new residual corporation can, if appropriate, develop a plan under the CCAA to compromise the remaining liabilities.

Reform

33. What recent reforms or proposals for reform affect private equity?

Corporate Transparency Regimes

Amid the global push for greater corporate transparency, various Canadian jurisdictions have been pursuing legislative amendments to ensure corporations hold accurate and up-to-date information on beneficial ownership that will be available to law enforcement, tax, and other authorities. To date, amendments have been passed (federally and in a number of provinces including Ontario, British Columbia, Manitoba, Nova Scotia, and Saskatchewan) to require that subject corporations maintain a private register of beneficial owners and make that register available for inspection by certain regulatory authorities and stakeholders for specified purposes.

The requirements currently in force can be an administrative burden for PE portfolio companies, as they require the company to make enquiries regarding its upstream ownership structure and sometimes require PE funds to disclose information regarding their underlying investors in the portfolio company. However, given the mostly private nature of underlying registers, this is not a great cause for concern.

However, Québec has passed legislation, expected to come into force in 2023, that will require any locally incorporated company and any other enterprise doing business in the province to disclose ultimate beneficial ownership information (for owners at or above a 25% voting or economic interest level or that exercise de facto control) to the enterprise register, which would then be made publicly available.

The Canadian federal government has also announced intentions to amend the Canada Business Corporations Act to implement a public and searchable beneficial ownership registry before the end of 2023.

Change in Tax Treatment of Stock Options

Amendments were enacted to the ITA in 2021 that limit the effective capital gains treatment for employee stock options (see *Question 28*) granted after 1 July 2021. These amendments impose a per-vesting year limit capped at CAD200,000 of the underlying securities to which the options relate, by fair market value, as of the time the stock option agreement is made. This means the limit generally tracks, by vesting year, the first CAD200,000-worth of securities valued as of the agreement date. Above that cap, stock options do not benefit from capital gains-like treatment.

This new cap does not apply to CCPCs or to companies with gross revenue below CAD500 million.

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