

# NEGOTIATED MERGERS AND ACQUISITIONS

2007 was a banner year for Canadian M&As but the pendulum is swinging and the game is changing. Where does it go from here?

By Richard B. Epstein, *BCF LLP*

The events that impacted the M&A world in 2007 will have a significant influence on how and by whom deals are concluded at least over the short to medium term. It is expected that the types of transactions and the acquirers initiating them will change in a material way, as will some of the terms of the purchase and sale agreements (“PSAs”) to implement negotiated acquisitions, for a variety of reasons.

In Canada, as in the United States, private equity funds with access to relatively inexpensive debt went on an unprecedented spending spree in 2007. A large number of high profile cross-border take-overs of Canadian companies were announced in 2007, including the acquisition of Alcan, BCE, Cognos, IPSCO, LionOre, PrimeWest Energy and Stelco. Canadian companies including Investors Group, Great-West Life, Gerdau Ameristeel and TD Bank were active in making some of the year’s largest Canadian acquisitions abroad.

Overall, 2007 was a banner year for Canadian M&A. Based on data supplied by Thomson Financial, KPMG reported that cumulatively there were more inbound, outbound and domestic deals completed in 2007 than ever before. The number of outbound deals (Canadians buying businesses abroad) actually exceeded the number of inbound deals (foreign take-overs of Canadian businesses), although by dollar value inbound deals exceeded outbound deals. These results occurred despite a significant slowdown in M&A activity in the second half of the year.

The deal pendulum has swung back, away from private equity sponsored acquisitions, as the credit crunch has made debt more expensive and less available. The return on investment for private equity firms is just not there as a result of the current financing and economic markets. In the second quarter of 2007, the best ever in terms of deal value according to Canadian investment banking firm Crosbie & Co., financial sponsors were involved in 42 percent of announced M&A deals of greater than \$100 million.

With an important slowdown in the US economy, corporate profits of potential target companies on both sides of the Canada-US border will be increasingly insufficient to service the debt that would result from mergers with acquisition companies backed by private equity funds. For 2008, these circumstances will result in a proportionately greater number of strategic acquisitions (by competitors of the targets or other industry players looking to complement or diversify their businesses and rationalize costs), opportunistic acquisitions where the target is financially challenged and vulnerable, and take-overs by foreign state-owned enterprises (“SOEs”) that have accumulated cash and which meet the new criteria established for investing in Canada, as will be discussed further in this article.

## Factors Dominating the Canadian Context

One of the most significant economic factors in

2007 from a Canadian perspective was the evolution of the exchange rate with the US dollar. The Canadian dollar appreciated considerably against the US dollar, starting the year at US\$0.86 and peaking in the month of November at US\$1.09. The last time the Canadian dollar even reached parity with the US dollar was 32 years ago.

This ascent was driven in part by the rise in the price of oil, the demand for Canadian natural resources by developing economies (China and India, for example) and the general depreciation of the US dollar against other currencies. High oil prices and natural resource prices attract, and are likely to continue to attract, acquisitions of Canadian companies by foreign entities. The Canadian dollar was hovering at or just below parity at the beginning of 2008.

Over the same period, the Canadian dollar appreciated from €0.65, peaked at €0.74 and ended the year a bit ahead of where it started the year at €0.69. This rise in the Canadian dollar made acquisitions by Canadian purchasers of US businesses less expensive. Non-US foreign purchasers have no reason to be deterred by this evolution of the value of the Canadian dollar.

To a large extent due to the demand for commodity exports, the Canadian economy as a whole was strong and growing in 2007. However, certain sectors continued to suffer, for example manufacturing and forestry products, primarily due to lower labor and other production costs in foreign markets and weak demand from the US. Other exports from Canada to the US have declined, due mainly to the appreciation of the Canadian dollar, which has made Canadian goods and services more expensive to American importers. This situation is weakening the financial position of many Canadian exporters and putting some of them in distress.

In recent years, American and other foreign interests have acquired a large number of sizable Canadian businesses, including such icons as the Hudson's Bay Company, Alcan, Bell Canada (completion pending) and even the sacred Montreal Canadiens Hockey Club. Already in 2008, Alliant Techsystems, a US company, agreed to acquire the division of MacDonald Dettwiler that developed the revered Canadarm space shuttle technology.

The Canadian federal government has come under increasing pressure to study and combat the

perceived hollowing-out effect of foreign acquisitions on corporate Canada. The government announced the creation of the Competition Policy Review Panel

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on July 12, 2007 to review key elements of Canada's competition and investment policies, to ensure that they are working effectively. The Panel released a consultation paper on October 30, 2007 and should report back to the government by June 30, 2008.

## Legislative Developments in Canada

### 1. Foreign Investment Review

Foreign investment in Canada is regulated in a general way under the *Investment Canada Act* (the "ICA") through the application of a "net benefit to Canada" test. The Canadian government has been considering the effectiveness of the legislation in light of the increased globalization of M&A of recent years, and on December 7, 2007 announced two new measures. Firstly, in response to the major increase in international investment by SOEs, the government adopted guidelines under the ICA to clarify how it will assess the acquisition of Canadian businesses by SOEs. Assessment will focus on the SOEs' adherence to Canadian standards of corporate governance and reporting and its respect of Canadian law, as well as the ability of the Canadian target to operate on a commercial basis. The Canadian government will seek specific undertakings in this regard from the SOEs to address its concerns.

Secondly, the government is considering amending the ICA to establish a national security test for the purpose of safeguarding national security and sovereignty. Such amendment is not expected to be adopted until later in the year and could be delayed further if there is a federal election. The government's stated position remains to promote foreign investment in Canada however acquisitions of control of Canadian businesses are to be scrutinized more closely from these perspectives in the future.

## 2. Tax Matters

On September 21, 2007, Canadian and American government officials signed the Fifth Protocol (the "Protocol") to the Canada-US Tax Treaty (the "Treaty"). When the Protocol comes into force (expected Spring

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2008), changes to the Treaty will impact, among other things, certain structures commonly used to implement cross-border transactions. For example, Treaty benefits will now be extended to investors in US LLCs thereby permitting US residents to use that vehicle for investment purposes in Canada and therefore be taxed at reduced Treaty rates on Canadian income and gains in specific circumstances.

Another example is the use of unlimited liability companies in Canada that, as a result of unanticipated wording in the Protocol, may lose their ability to claim Treaty benefits as of 2010. Also as a result of the Protocol, withholding tax on interest paid by Canadians to US residents (and vice versa) shall be eliminated altogether, removing the need to rely on the five year, 25 percent capital repayment exemption, and resulting in a reduction in borrowing costs,

thus making cross-border investment more efficient.

Other proposed changes under draft legislation in Canada will impact international tax planning for Canadian corporations by making interest related to the funding of foreign affiliates non-deductible in certain circumstances. Accordingly, not all of the announced tax changes will have a favorable impact on parties involved in cross-border transactions.

## 3. Uniform Securities Transfer Legislation

Over the last year or so, a number of Canadian provinces have proposed and in some instances already enacted legislation modelled on the *Uniform Securities Transfer Act* that was agreed upon by all of the Canadian provinces and territories. This legislation, which follows Article 8 of the US *Uniform Commercial Code*, harmonizes the rights and obligations of issuers of securities, investors, securities intermediaries and secured creditors. More specifically, it establishes rules relating to how securities are to be transferred or pledged.

The legislation should have a generally favorable impact in completing domestic and cross-border transactions, primarily in the context of take-overs where stockholders hold the stock issued to them indirectly through intermediaries. Where selling stockholders hold their securities directly, however, the impact of such new legislation, where enacted, is unlikely to be material.

## 4. Merger Review

A couple of interesting court challenges and a legislative development occurred in 2007, all in respect of the Canadian merger review process, that practitioners and parties involved in cross-border transactions should know about. Prior to 2007, there was a common practice of granting the Competition Bureau (the agency responsible for the administration and enforcement of merger review in Canada) more time than the statutory waiting periods to complete its review of a merger. This will no doubt change as a result of the Labatt-Lakeport merger and more specifically the successful judgments obtained by the merging parties in response to court applications made by the Commissioner of Competition.

For a variety of reasons, including the Competition Bureau's rigorous adherence to the service standards and time frames for merger review that it publicly established for itself as well as the perceived ease with which the Commissioner of Competition could obtain an interim order to prevent a merger from proceeding, parties to complex mergers often negotiate with the Competition Bureau, formally or

informally, matters including the time frame within which the review process by the Competition Bureau will be completed.

In considering an application by the Commissioner of Competition for an interim order against Labatt and Lakeport, the Competition Tribunal ruled on March 28, 2007 that no extension of the review period would be granted as the Commissioner failed to establish that without the interim order, the remedial powers afforded to the Competition Tribunal would be substantially impaired. This decision is now the leading case on interpreting the standard that the Competition Bureau must meet to obtain an interim order and was upheld on appeal to the Federal Court of Appeal on January 22, 2008.

To make matters worse for the Competition Bureau and in respect of the same transaction, as a result of an application made by Labatt and Lakeport, on January 18, 2008 the Federal Court also set aside the order it granted on November 8, 2007 requiring the parties to the transaction to produce documents and information. The Commissioner of Competition had obtained the order pursuant to an *ex parte* application and when the order was subsequently challenged, the court found that disclosure made by the Competition Bureau in support of the application was misleading, inaccurate and incomplete. Both decisions will likely encourage other merging parties to challenge orders sought or obtained by the Commissioner of Competition.

On the legislative side, amendments to the *Canada Transportation Act* were enacted on June 22, 2007 that established an additional merger review process, in parallel with the general merger review under the Canadian competition legislation. Where a proposed merger involving a "transportation undertaking" under federal jurisdiction is intended to be completed and that transaction is subject to pre-merger notification under the *Competition Act*, the transaction is now also subject to review by the federal Transport Minister. This additional review seeks to ensure that public interest issues arising out of such mergers are properly considered and addressed. The parties to the transactions will have the opportunity to respond to the issues raised and offer undertakings to alleviate any concerns. Ultimately, however, such transactions can be delayed or prohibited pursuant to this new review process.

## Impact on Negotiated Acquisitions in Canada

The roller coaster ride of 2007, caused by factors

such as the glut of inexpensive debt immediately followed by the credit crunch, the rapid and significant depreciation of the US dollar, the ripple effect on the Canadian economy of the US economic slowdown, the legislative developments in Canada referred to above as well as other factors have contributed to the instability of M&A transactions generally.

Deals reached become unattractive before the necessary steps to get to closing a few months later have been completed, due to a variety of intervening developments, some of which are entirely unforeseeable to the parties to the transaction. Because of the rapid rate of change, buyers need to devote more attention and energy to negotiating and drafting provisions in PSAs, in order to reduce the impact of these changes and to be able to get out of or renegotiate deals that no longer make sense.

### 5. Reverse Break-up Fees

With the merger frenzy of the last few years behind us now, the balance of power in negotiations is shifting more towards the buyers. This will allow buyers to better protect themselves against the impact of potential unexpected circumstances. It was the sellers' market that popularized reverse break-up fees in M&A transactions a few years ago. Sellers were in a position to oblige buyers to compensate them for the buyer not proceeding with the deal, generally as long as the failure to conclude the transaction was not attributable to the seller. If buyers are not able to eliminate reverse break-up fees altogether, at least not just yet, they are certainly in a better position to limit the circumstances in which such fees will be payable.

Looking at the same issue from a different perspective, sellers are rarely inclined to grant pure options to purchase to potential buyers. However, when coupled with appropriately tailored conditions which trigger the break-up fee, parties to negotiated transactions can achieve a better balance in sharing the risks of intervening events. The buyer can walk away from the deal with its damage limited to the break-up fee if certain specified conditions, more personal in nature to it and its circumstances, are not fulfilled and assuming specific performance is properly excluded from the recourses available to the seller.

The issue of limiting liability to a specified amount of money and excluding the seller's recourse to specific performance was considered in detail in the decision rendered on December 21, 2007 by the Court of Chancery of the State of Delaware in *United Rentals, Inc. v. RAM Holdings Inc. and RAM Acquisitions Corp.* The judgment makes for an inter-

esting read in respect of M&A negotiations, changing market contexts and the interpretation of contracts. The court had to interpret ambiguous drafting and contradictory provisions in deal documents as well as oral testimony with respect to negotiations to reach a conclusion as to the common understanding of the parties — that specific performance was unavailable to the would-be seller.

## 6. Closing Conditions

One of the more important challenges of late in negotiating PSAs is negotiating the conditions for closing. This is irrespective of whether the seller agrees to limit its recourses by accepting a break-up fee from and renouncing specific performance against a buyer unwilling to complete a transaction. Buyers need to identify important potential eventualities that may arise and that could have a significant impact on their interest to close a transaction.

The return of the buyer's condition of obtaining financing is an obvious one that was not regularly included in deals in Spring of last year. If the buyer requires specific up-to-date information in respect of the target which is not available at the time the PSA is signed (for example, current financial results), the agreement should include a condition to the effect that the missing information must be provided by the target and that the buyer must be satisfied with such information. If it does not, it may be difficult or impossible for the buyer to simply rely on the general due diligence condition (provided it is still operative) for not closing the transaction, claiming that it is not satisfied with what it has seen.

Similarly, not obtaining the missing information until after entering into the PSA and then relying on the a material adverse change ("MAC") condition to get out of completing a transaction once the information is provided could prove to be problematic. This was one of the key issues in the December 27, 2007 decision of the Chancery Court of the State of Tennessee in *Genesco, Inc. v. The Finish Line, Inc., et al* and is discussed below in the context of MAC provisions in PSAs.

## 7. MAC Provisions

Given the existence of rapidly changing variables that affect transactions, the importance of a well-negotiated and well-articulated MAC provision in a PSA has only increased. This is all the more true in the Canadian context as there is an absence of authoritative judicial interpretation relating specifically to MAC provisions. To reduce the risk of recourse to the courts, parties to transactions, particularly in

turbulent times, need to clearly stipulate what does and what does not constitute a material adverse effect ("MAE").

The risk of occurrence of identifiable or foreseeable events that the buyer requires to be able to rely on as grounds for not completing a transaction should be the object of specific conditions to closing, to the extent acceptable to the seller, as discussed above. Negotiation of the MAC provision, however, is essentially focused on excluding what the parties agree should not be considered to constitute an MAE in respect of the target.

In a seller's market, changes in general economic conditions, financial markets or applicable law that do not in a materially disproportionate manner affect the target as compared to its competitors are examples of common exclusions from the definition of an MAE. In a buyer's market, the scope of exclusions will no doubt be narrower. In addition, it may also be helpful to specify a dollar threshold above which the impact of an unforeseen event would necessarily constitute a MAC. Strategic buyers should not expect, however, to

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benefit from as broad a definition of an MAE that a financial investor might now require, in light of their industry knowledge and expertise.

In the Genesco case referred to above, the court was called upon to interpret the MAC provision contained in a merger agreement according to which

a strategic buyer committed to acquire the target and its lender committed to finance the leveraged buyout. The decline in the target's performance following the signing of the merger agreement was ultimately found to constitute an MAE, on the basis that it was material and not of a short term duration.

However, because the MAE was due to general economic conditions and the MAC provision expressly excluded general economic conditions from the applicable definition, the buyer and its lender could not rely on the MAC provision for not closing. Furthermore, the court granted the target's request for specific performance and ordered that the transaction be completed on the basis that no other adequate remedy existed, the merger agreement was not inequitable and specific performance would not produce a futile or harsh result.

This decision provides useful insight into how MAC provisions may be interpreted and therefore how carefully they should be negotiated, the importance of stipulating specific closing conditions that are critical to the buyer and the importance of addressing the remedies for breach of contract, particularly in volatile markets.

## 8. Arbitration Clauses

For reasons such as expediency, the parties' ability to choose specialist adjudicators as well as for confidentiality purposes, arbitration should gain in popularity as an alternative to court action to settle disputes among transacting parties, particularly in cross-border transactions where the enforcement of foreign judgments can raise complicated issues. Properly drafted arbitration clauses are essential to ensuring that the jurisdiction of the courts is effectively excluded.

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## Anticipated Trends for 2008

The Economist Intelligence Unit is the business-to-business arm of the Economist Group (which includes *The Economist* magazine). It performs country analysis on more than 200 markets and it has projected that Canada will be "the best country in the world with which to do business in 2008." Hopefully this projection will prove to be accurate and will extend to the acquisition markets as well, both inbound and outbound.

Some anticipated trends which are expected to influence M&A transactions inbound into Canada in 2008 and how they will be completed, as compared to 2007, are as follows: there will be fewer acquisitions of Canadian companies; deal sizes will be smaller and purchase prices will be more conservative; a greater proportion of buyers will be strategic purchasers; more SOEs will seek to acquire Canadian companies; a greater proportion of sellers will be distressed companies; there will be less competition among buyers for targets and the negotiating power for buyers will increase.

If these anticipated trends materialize and particularly if there is a climate of economic uncertainty or instability in the market generally, some of the consequences from an M&A perspective are likely to be that: the terms and conditions in negotiated acquisitions which allocate and protect against risks and recourses will become even more critical; purchase and sale agreements will require more time and energy to conclude; foreign investment review will become more substantive; complex merger review will become more frequent and cross-border collaboration in acquisitions in the insolvency context will become more important. Because of these factors, it may be more challenging to close negotiated acquisitions in Canada in 2008.

