

10 tips for U.S. professionals doing private M&A deals in Canada

January 10, 2022

Written by [Neil Ezra Hazan](#).

American strategic and private equity buyers seeking to purchase private companies in Canada often have a common set of questions and preoccupations based upon their U.S. transactional experience. The following is a high-level summary of key points that frequently come up in cross-border deals involving Canadian targets.

1. Jurisdictional matters and the uniqueness of Québec deals

Each of Canada's provinces and territories have their own legal system and regulatory framework, with Canadian federal law being applicable in all provinces and territories. Of the 10 provinces north of the border, nine have legal systems rooted in the English common law tradition and one province, Québec, whose private laws are set out in a Civil Code with French Napoleonic roots.

Contrary to the U.S., where non-Delaware parties frequently agree for their contracts to be governed by Delaware law, the Canadian marketplace tends to be more sensitive to local legal differences and customs. One consequence of this is that it is rare for Canadian sellers to agree to be bound by contracts governed by laws other than those of a Canadian province. In our experience, even though U.S. buyers often have compelling arguments for U.S. laws and jurisdictions, Canadian sellers tend to be apprehensive about U.S. laws and even more apprehensive about U.S. courts for numerous reasons, including potentially outlandish damage awards given the more litigious nature of the U.S. market. The wariness of non-local law is even more pronounced in Québec, not only due to linguistic reasons, but also because of Québec's unique legal and cultural environment.

This resistance to U.S. laws can appear in preliminary discussions respecting non-disclosure agreements and even non-binding letters of intent..

2. Good faith in letters of intent

While good faith in contractual performance has long been a feature of Québec civil law, the Supreme Court of Canada recently recognized the “organizing principle” of good faith in Canada’s common law provinces. While good faith performance is not particularly surprising to U.S. deal professionals, they are often surprised to learn that in Québec, the obligation to act in good faith is applicable in pre-contractual discussions. This obligation is of “public order” and cannot be derogated from contractually (even with explicit “non-binding” language), and as a result, care must be taken to ensure that buyers are acting in good faith during negotiations since obligations can intensify as ostensibly non-binding discussions become more serious.

A practical consequence of the foregoing is that there have been a number of successful claims launched by sellers and targets in Québec against presumptive buyers that have been found to be negotiating in an abusive manner.

3. Types of entities and numbered companies

In Canada, typical entities seen on cross-border transactions are corporations, partnerships and trusts. Canada does not have a C-Corp vs. S-Corp distinction and the concept of a limited liability company (LLC) does not exist in Canada. That said, unlimited liability corporations (ULCs) under the laws of Nova Scotia, British Columbia and Alberta are sometimes seen on cross-border deals where they are deemed to be flow-through entities for U.S. purposes by the IRS and viewed as ordinary corporations for Canadian income tax purposes.

It is also worth noting that federal and provincial jurisdictions grant incorporators the right to form a corporation with no name other than, for example, 1234567 Canada Inc., 1234-5678 Quebec Inc. or 1234567 Ontario Ltd. This common approach is expedient and can be helpful in order to avoid trademark infringement risk.

4. Typical deal structures and representation & warranty insurance

In the U.S., the most common acquisition structures are share acquisitions, asset acquisitions and mergers. In Canada, share acquisitions and asset acquisitions are most prevalent and operate very similarly to those in the U.S., though mergers are usually seen only in a public M&A context or in the context of a statutory, court-approved arrangement.

Irrespective of deal structure, like in the U.S., M&A transactions can be insured by representation and warranty insurance. While procuring such insurance is very similar in both countries, there are some particularities of the Canadian market worth noting. First, **there are fewer insurers underwriting deals in Canada than in the U.S., and even less capacity for Québec insureds due to current legislation increasing insurer liability for defence costs over and above policy limits in that province.** Second, notwithstanding the smaller field of insurers, insurance rates are slightly cheaper in Canada due to **less competition for deals and the country’s less litigious business environment.** Third, in contrast to the surplus lines tax that is levied on American insureds which is typically in the 3-5 per cent of premium range, in Canada there are premium taxes that can be quite significant (for example, 8 per cent in Ontario and 9 per cent in Québec).

5. Canada's lifetime capital gains exemption

Canadian residents have the right to a one-time capital gains exemption, allowing individuals to realize tax-free capital gains upon the disposition of certain types of property. The lifetime capital gains exemption is \$1,016,836 in 2024. New budget proposals aim to increase this limit to \$1,250,000. The amount of this exemption, along with the fact that it can be multiplied with effective long range tax planning, often leads Canadian individual sellers of businesses to favour share sales and U.S. buyers should bear this common Canada-specific preference in mind when structuring transactions.

In order for individual sellers to take advantage of the capital gains exemption on “qualified small business corporation shares”, there are certain requirements regarding the shares and assets of the target company depending on whether or not the company is carrying on active business in Canada or whether it is a mere holding company of passive investments. A transfer of shares of a company not fulfilling these share and asset requirements will prevent the individual shareholder from benefiting from the exemption. In certain circumstances, a company may fail the asset test if the company owns, for example, stock of a subsidiary. As a result, U.S. buyers should bear in mind that individual sellers carrying out private share sales will often want a structure that allows them to take advantage of their lifetime capital gains exemptions.

6. Sales tax exemptions in asset purchases

Federal goods and services tax (GST) and its provincial analogs paid by buyers vary in rate and mechanics from province to province and can often amount to 15 per cent of the cost of a particular transaction. While the payment of GST is ordinarily required when purchasing the assets of a business, such sales taxes are often reclaimable by asset buyers in the reporting period following the closing of an asset purchase. That said, buyers could typically avoid the cash outlay for GST at closing by filing what is commonly called a “Section 167 election”.

7. Reverse earn-outs

Earn-outs are a mechanism whereby a buyer pays a seller additional consideration in the event that a target company sold to the buyer performs above certain pre-negotiated levels. In Canadian asset sales, earn-outs are taxed as income in the seller's hands. Oddly, the Canada Revenue Agency (Canada's IRS) does not tax earn-out consideration as income if the relevant earn-out clause is drafted as a “reverse earn-out” whereby the maximum consideration is payable, unless the relevant thresholds are not met and, as a result, the maximum consideration is reduced. In such a case, the purchase price would be taxed as capital gains at a lower rate.

By way of example, an earn-out would read: “The purchase price for the purchased assets is \$50 million, however if the target company achieves \$10 million in sales in the year following closing, the purchase price will be increased to \$52,000,000.”

A reverse earn-out describing the identical business deal would state: “The purchase price for the purchased assets is \$52,000,000, however if the target company does not

achieve \$10 million in sales in the year following closing, the purchase price will be decreased to \$50 million.”

The earn-out/reverse earn-out distinction is typically applicable to asset acquisitions (as opposed to share acquisitions); however, due to the conservatism of Canadian tax lawyers and accountants, reverse earn-out drafting gymnastics are commonly employed in share acquisitions as well.

8. Taxation of stock options

The taxation of stock options in Canada is extraordinarily complex and therefore transactional lawyers, tax lawyers and accountants on Canadian deals often spend a fair amount of time mitigating tax risk due to often sub-optimal stock option plans and equity compensation introduced long before a proposed transaction. Please [see BLG's primer](#) for a more in-depth summary on the taxation of equity compensation in Canada, which provides helpful background for buyers seeking to collapse existing plans and those seeking to implement a going-forward equity compensation plan consistent with their commercial and tax aims.

9. Employment considerations in asset purchases

When planning an asset purchase in Canada, buyers need to pay careful consideration to applicable labour and employment laws, which differ markedly from those in the U.S.

In Québec, unionized and non-unionized employees transfer from an asset seller to asset buyer by operation of law, and both the asset seller and the asset buyer are joint and severally liable toward the employees for employment-related obligations. Québec asset sellers can agree to terminate employees before the sale in an asset purchase agreement, however that approach can result in demands for increased purchase price to compensate seller for its termination costs. Also, the choice of employees to be terminated must be carefully considered as the selection process may require the buyer to consider seniority, even where the assets are not part of a unionized facility.

In the rest of Canada, there is no automatic transfer of non-unionized employees. An asset buyer can decide which employees to make offers to, subject to discrimination protections under human rights legislation, such as disability and age. If an employee is not offered employment or does not accept an offer, the asset seller typically remains liable for any termination obligations. For unionized employees, applicable collective agreements and provincial labour legislation need to be considered.

10. The Investment Canada Act

The Investment Canada Act (ICA) governs foreign investment in Canada. It contains two separate review processes:

- a. a “net benefit to Canada” review process, which only applies to acquisitions of control of Canadian businesses by entities ultimately controlled by non-Canadians where certain financial thresholds are exceeded; and

- b. a national security review process which can apply to all investments into Canada by non-Canadians and which is conceptually similar to the U.S. CFIUS process.

Practically, for American-controlled entities acquiring businesses with operations in Canada, if there is no foreign state ownership supporting the buyer, the primary concerns under the ICA are if one or more of the following conditions are present:

- i. if the enterprise value of the Canadian business is over C\$1.989 billion;
- ii. if the Canadian business is in a “cultural” industry (publishing, film, music, video games or broadcasting); or
- iii. if the Canadian business is involved in defence, public health or the supply of critical goods and services.

If none of these conditions are present, there is likely no practical risk under the ICA. However, if any are present, it may be required or advisable to secure clearance prior to closing a transaction, and the federal government may require buyers to enter into binding contractual commitments in order to secure approval. In most cases, approval can be secured for American buyers, but in limited cases the government could seek to block investments or order divestiture of those already completed.

It is also important to note that amendments to the ICA have passed and will take effect in the reasonably near future (the date is not yet determined). The primary impact of these amendments for U.S. investors will be that certain investments in certain critical sectors (to be determined) by non-Canadians - including U.S. investors - will require mandatory pre-closing notification under the ICA and the application of a suspensory waiting period. We will update this guidance when the affected sectors and the effective date are announced.

Key takeaway

While private Canadian deals have a lot in common with those carried out in the U.S., deals north of the border often have unique characteristics due to Canada’s distinct private law and regulatory environment. While there is no substitute for retaining experienced Canadian deal counsel with relevant cross-border experience to delve into the particulars of each situation, this primer is intended to give U.S. deal professionals a sense of some of the key issues that they may encounter on Canadian transactions.

For more information on how [BLG's Mergers & Acquisitions](#) team can help you, please reach out to [Neil Ezra Hazan: NHazan@blg.com](mailto:NHazan@blg.com) or 1.514.954.2511.

By

[Neil Ezra Hazan](#)

Expertise

[Mergers & Acquisitions](#), [Labour & Employment](#), [Tax](#), [Corporate Commercial](#), [United States](#)

BLG | Canada's Law Firm

As the largest, truly full-service Canadian law firm, Borden Ladner Gervais LLP (BLG) delivers practical legal advice for domestic and international clients across more practices and industries than any Canadian firm. With over 725 lawyers, intellectual property agents and other professionals, BLG serves the legal needs of businesses and institutions across Canada and beyond – from M&A and capital markets, to disputes, financing, and trademark & patent registration.

blg.com

BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749

The information contained herein is of a general nature and is not intended to constitute legal advice, a complete statement of the law, or an opinion on any subject. No one should act upon it or refrain from acting without a thorough examination of the law after the facts of a specific situation are considered. You are urged to consult your legal adviser in cases of specific questions or concerns. BLG does not warrant or guarantee the accuracy, currency or completeness of this publication. No part of this publication may be reproduced without prior written permission of Borden Ladner Gervais LLP. If this publication was sent to you by BLG and you do not wish to receive further publications from BLG, you may ask to remove your contact information from our mailing lists by emailing unsubscribe@blg.com or manage your subscription preferences at blg.com/MyPreferences. If you feel you have received this message in error please contact communications@blg.com. BLG's privacy policy for publications may be found at blg.com/en/privacy.

© 2024 Borden Ladner Gervais LLP. Borden Ladner Gervais LLP is an Ontario Limited Liability Partnership.