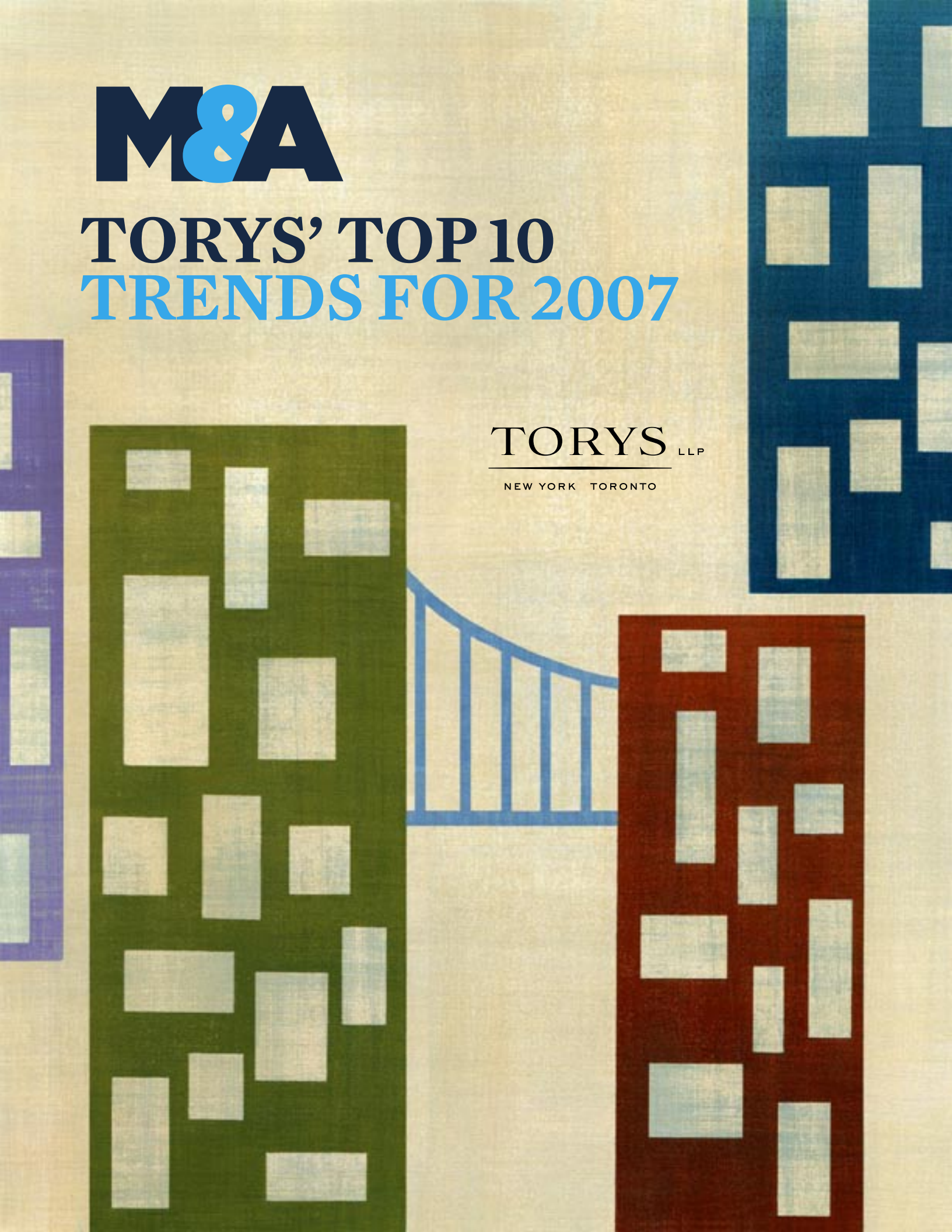




# TORYS' TOP 10 TRENDS FOR 2007

TORYS LLP

NEW YORK TORONTO





# TORYS' TOP 10 TRENDS FOR 2007

Merger and acquisition activity during 2006 continued at record levels, and no end is in sight. We are in the midst of a “perfect storm” of circumstances that could cause a huge movement of large public companies out of the hands of public shareholders and into the hands of private equity and institutions.

The impetus for this shift is being fuelled by cash-rich private equity funds; the emergence of clubs that enable these funds to do much bigger deals; the growing unfriendliness of the regulatory environment for public companies; and the pressure for short-term earnings growth.

What are the implications of this movement for the economy, for regulators and for acquirors, targets and investors?

Torays' M&A lawyers are looking ahead to 2007, and here's what they see.

**1**

**Going-Private  
Transactions  
Will Increase**

**2**

**Sarbanes-Oxley Will Spur M&A  
Activity and Result in the Increased  
Importance of Non-U.S. Stock Exchanges**

**3**

**Income Trust  
M&A  
Will Grow**

**4**

**Defensive Tactics  
Will Proliferate  
and Strengthen**

**5**

**Private Equity  
Club Transactions  
Will Continue to Increase**

**6**

**Shareholder  
Activism  
Will Strengthen**

**7**

**Use of Go-Shop  
Clauses  
Will Increase**

**8**

**Independence of  
Financial Advisers  
Will Be Scrutinized**

**9**

**Telecom/Media  
Businesses  
Will Consolidate**

**10**

**India  
Will Expand  
Activity**

# 1

## Going-Private Transactions Will Increase

Over the last few years, there have been relatively few going-private transactions for large Canadian public companies in which management or significant shareholders have participated.

Notable examples include KKR's acquisition of Masonite; Magna's acquisition of the public's stake in its Intier, Decoma and Tesma subsidiaries; and the announced acquisition of Four Seasons Hotels by a group of investors, including the controlling shareholder.

Going-private transactions are legally complex and involve serious execution risk. Under Canadian securities rules, a going-private transaction that involves management or a significant shareholder will generally require a formal, independent valuation supervised by a special committee of independent directors and approval by a majority of the shareholders who are not associated with the acquiror or management.

Private equity acquirors often wish to work closely with management to formulate their strategy and conduct effective due diligence, and require management to maintain an ongoing equity stake in the business. However, management's involvement in these transactions presents a difficult challenge in light of a board's desire to have an even-handed, conflict-free auction.

Despite the complexity and challenges, we expect to see an increasing number of going-private transactions in 2007 as a result of the following factors.



- ➔ U.S. and other private equity funds are under pressure to effectively deploy the large amounts of capital they have raised in recent years. Private equity funds have the capital resources, financial expertise and ability to handle the complexity that can give them an edge over strategic buyers. With the advent of “club deals” (see trend #5), even very large public companies can potentially be acquired. In addition, interest rates remain relatively low, and lenders seem eager to participate in leveraged buyouts.
- ➔ It is easier for management to focus on and execute a long-term business strategy if the company is held privately. Canadian investor confidence laws, modelled on Sarbanes-Oxley, and Ontario's new liability-for-disclosure laws require boards of directors to pay serious attention to governance, disclosure and liability matters. Shareholders and financial markets are scrutinizing quarterly and other short-term performance objectives and results; long-term business strategies may be more difficult for public companies to execute.
- ➔ Two uniquely Canadian factors are also at play. First, the federal government's decision to tax income trusts similarly to the way it taxes corporations has significantly affected the market value and viability of some income trusts. Many income trusts are now considering going private. Second, Canada has a relatively high proportion of family-controlled companies that can deliver control to a buyer without an auction. This was seen in Bell Globemedia's acquisition of CHUM and the recent proposal to take Four Seasons Hotels private.

# 2

## **Sarbanes-Oxley Will Spur M&A Activity and Result in the Increased Importance of Non-U.S. Stock Exchanges**

Concern that the New York Stock Exchange and Nasdaq are now less attractive markets on which to list, particularly for foreign or emerging companies, has affected the competitiveness of U.S. capital markets. Sarbanes-Oxley is often blamed, with particular criticism aimed at the section 404 internal control requirements, which require public companies to assess their controls to ensure accurate financial reporting and require an external auditor to attest to the effectiveness of those controls. One survey calculated that the average cost of section 404 compliance in the initial 2004 year was US\$3.8 million, with the average cost in subsequent years dropping more slowly than expected. The Securities and Exchange Commission and the Public Company Accounting Oversight Board are seeking to reduce this burden, partly by focusing the standard on matters that are material. Other factors lessening the attractiveness of being a public company in the United States include the costs of regulation generally and the threat of class-action lawsuits.

The globalization of capital markets and the growth of local exchanges, both senior and junior, including the London Stock Exchange's Alternative Investment Market (AIM), have also affected U.S. capital markets. AIM concentrates on small and growing companies, and the exchange has posted significant growth of late, including listings of U.S. and Canadian companies. AIM offers more liberal listing requirements than the principal U.S. exchanges (e.g., no minimum company size, number of shareholders or financial track record) and less onerous regulation. The Toronto Stock Exchange and TSX Venture Exchange are also attracting initial public offerings of U.S. companies that consider themselves too small for the U.S. markets or wish to avoid the cost of U.S. regulation. A TSX listing offers liquidity as well as a less costly regulatory regime (e.g., no requirement for auditors to attest to internal control over financial reporting).

In 2007, we expect that the costs and onerous regulatory regime facing U.S. public companies will continue to provide opportunities for private equity firms to take companies private and for other exchanges to obtain new listings. We also believe that companies will continue to structure their M&A transactions to avoid full U.S. regulation if suitable alternatives exist.

# 3

## **Income Trust M&A Will Grow**

Income trusts had been increasing their M&A activity over the past several years as management teams looked to grow their businesses, aided by easy access to robust equity markets. Even with a relatively soft IPO market for income trust issuers in 2006, numerous public and private market M&A transactions took place (e.g., Avion's acquisition of Atlas Cold Storage; Canadian Public Sector Pension Investment Board's acquisition of Retirement Residences REIT; Welsh, Carson, Anderson and Stowe's acquisition of ACS Media; and Macquarie Infrastructure's proposed acquisition of Halterm).

The big news for income trusts, of course, was the federal government's October 2006 announcement that income trusts would be taxed similarly to corporations. The new taxation rules are expected to come into effect in 2007 for all income trusts that become publicly traded on or after November 1, 2006, and in 2011 for all existing income trusts. This announcement shocked the income trust sector, sending issuers and their advisers scrambling. Unfortunately, a great deal of uncertainty remains while we await the implementation of the new tax regime.

We expect that income trust M&A activity will increase as units trade at depressed values and issuers become more affordable takeover targets, and that this heightened activity will accelerate during 2007. These transactions may take the form of management buyouts (supported by funding from private equity firms) or public takeover bids within the income trust sector. The takeover transactions will be either friendly or hostile and may be strategic or consolidation acquisitions.

# 4

## Defensive Tactics Will Proliferate and Strengthen

In recent years, several high-profile Canadian public companies have been acquired by non-Canadian companies, with large acquisitions in the mining, steel, and oil and gas industries. These transactions have raised concerns about the hollowing out of corporate Canada and strategic national security. Some experts believe that Canadian public companies are unusually vulnerable to international acquisitions because Canadian laws restrict defensive tactics more than the laws of other countries do. Canadian regulators have arguably moved too far in ensuring that sale decisions are made by the shareholders, who may be overly focused on short-term gains at the expense of longer-term corporate and industry strength.

There are signs that the government and regulatory authorities are reviewing the broad area of takeover defences and that 2007 will see moves to strengthen takeover defences in Canada.

It remains to be seen whether Canadian regulators and courts will permit shareholder rights plans to stay in place in appropriate circumstances (instead of insisting in all cases that eventually the “plan must go”), giving more scope to directors of Canadian public companies to “just say no” as is permitted in the United States and other jurisdictions. However, the federal government has announced a review of the effectiveness of the *Investment Canada Act* in the case of proposed acquisitions by entities related to foreign governments.



# 5

## Private Equity Club Transactions Will Continue to Increase

Large buyout firms combined to make several important acquisitions in 2006. Examples of these “club deals” include the announced US\$21.8 billion buyout of Kinder Morgan by Goldman Sachs Capital Partners, American International Group and The Carlyle Group; the US\$33 billion buyout of HCA by a consortium including KKR, Bain Capital Partners and Merrill Lynch Global Private Equity; and the announced sale of Freescale Semiconductor for US\$17.6 billion to a consortium including The Blackstone Group, Texas Pacific Group, The Carlyle Group and Permira Advisers.

By joining forces, private equity firms significantly increase their range of potential acquisition targets. Club deals also allow firms to spread the costs and risks of larger investments across a broader pool of investors and to partner with strategic investors or other sponsors that have sectoral experience.

Club deals are not without risk. Participation by several investors brings added complexity to deal execution and ongoing management of the acquired company; multiple investors may complicate workouts if an investment gets into financial difficulty; and these deals can give rise to antitrust and competition law issues. In early October 2006, the U.S. Department of Justice (DOJ) requested information from a number of prominent U.S. private equity firms regarding their participation in club deals, including their bidding practices. In November 2006, a class action alleging antitrust violations stemming from recent club deals was started in New York district court against 13 major private equity firms. Although it is too early to predict the outcome of the DOJ investigation, it is unlikely that club deals in and of themselves raise significant competition law issues under Canadian law.

We expect to see club deals continue in 2007 as cash-rich private equity funds pursue larger deals. In Canada, pension funds are likely to continue their move into the private equity space, with some funds executing transactions on their own, and an increasing number of pension funds participating in club deals, as co-investors with private equity firms.

# 6

## Shareholder Activism Will Strengthen

We expect shareholder activism, particularly through hedge funds and mutual funds, to increase in 2007. Fund activists buy a stake in a company to influence corporate policy, force change and, ultimately, increase shareholder value. They accumulate a significant stake, usually more than 5% of the outstanding shares of the target entity, and then disclose that stake to the market. The market tends to respond by driving up the stock price in the short term. Some funds go further, engaging in proxy battles (or even launching takeover bids) for the company to effect a sale or an increase in dividends or to change management and control. In 2006, this technique was employed by Third Avenue Management when it made a partial bid for the shares of Catalyst Paper, ultimately acquiring a significant block of outstanding shares and securing representation on Catalyst Paper's board of directors.

Hedge funds also buy shares of companies that are already in play or the subject of one or more outstanding bids. Large holdings by hedge funds can influence the outcome of a bidding war. As hedge funds typically have a short-term investment strategy, they tend to look for short-term gains and are unlikely to be swayed by the promise of long-term gains through synergies or other management strategies. This dynamic was evident in 2006 during the bidding war for Falconbridge. Inco's promise to deliver higher value in the long term was ultimately rejected by hedge funds in favour of Xstrata's higher all-cash bid.

In one extreme response to these practices, the Institute for Governance of Private and Public Organizations recently called for new rules banning shareholders from voting unless they have owned shares for at least one year. Although we believe that this proposal is probably not workable, it is an indication of the concerns raised by what is seen to be short-term thinking by hedge funds.

# 7

## Use of Go-Shop Clauses Will Increase

We expect to see increased use in 2007 of “go-shop” clauses in merger agreements and support agreements. A go-shop clause is the opposite of the usual “no-shop” clause (which prevents a target from actively soliciting buyers). It provides the target with a limited period of time to canvass the market for other purchasers and is intended to give the target board comfort that it can satisfy its fiduciary obligations when there has been only a limited auction or none at all. Typically, the board will agree to pay a smaller-than-usual break fee if a competing transaction is agreed to during the go-shop period. The break fee will usually increase after the go-shop period expires.

Go-shop clauses are being used more frequently in the United States but are still rare in Canada. In a recent example, Airsource Power Fund agreed to support an offer by Algonquin Power Income Fund, but included a go-shop clause that allowed Airsource’s independent liquidity committee to solicit alternative proposals.

We expect a go-shop clause to be used when a target company facing a proposed transaction has been unable to canvass the market or conduct an auction; such a clause would assist the target’s board in satisfying its fiduciary obligation to maximize shareholder value. The target board would have to be comfortable, however, that the go-shop clause would give it a meaningful opportunity to solicit a better offer. If some form of auction has already taken place, the go-shop clause is likely to be more restrictive (shorter period and larger break fee) and we expect that the purchaser would strongly resist any form of go-shop clause if an unrestricted auction has occurred. Another influencing factor will be the premium offered by the purchaser: the higher the premium, the less likely a purchaser will agree to a go-shop clause.

# 8

## Independence of Financial Advisers Will Be Scrutinized

Canadian securities laws do not specifically require boards or their special committees to use advisers that are independent of the company, its management and other interested parties, except when preparing a formal valuation. Directors in Canada have been comfortable relying upon opinions of financial advisers in M&A transactions even though the advisers may have other roles or relationships with other parties in the transaction. For example, special committees often obtain a fairness opinion from the financial adviser retained to oversee the sale process, who may be entitled to a success fee on completion of the transaction. The diverse roles played by advisers in some transactions reflect the practical reality that retaining advisers who are familiar with the company and the transaction is often the most efficient way for special committees to obtain the advice they need.

Although these practices have sparked some debate over the years, that debate has intensified in light of recent high-profile corporate governance failures and a heightened focus on corporate governance practices from regulators, stock exchanges, institutional investors and the media. Directors, who are themselves subject to close scrutiny when it comes to independence, are increasingly vigilant regarding the potential for conflicts among their advisers. In the M&A context, this has led more boards and special committees to take the cautious approach of retaining separate advisers who have no other roles or relationships with other parties in the transaction.

The issue of conflicts was addressed in a recent decision of the Delaware Court of Chancery (*In re Tele-Communications, Inc. Shareholders Litigation*). In that decision, the Court questioned “the quality and independence of the advice received” in light of the special committee’s reliance on the company’s legal and financial advisers.

The heightened awareness of conflicts is likely to mean that fairness opinions will be requested more often from a second firm of financial advisers that will not be entitled to a success fee on the transaction. We expect that directors will pay more attention to the terms of engagement of their advisers to ensure that their advisers’ incentives are aligned with the company’s and that the fee structure does not taint the process.

# 9

## Telecom/Media Businesses Will Consolidate

Following CHUM's acquisition by Bell Globemedia (which owns CTV and *The Globe and Mail*) in 2006, we expect further consolidation in 2007 in the Canadian broadcasting and media sector.

If the Canadian Radio-television and Telecommunications Commission changes its rules, this could remove hurdles to consolidation. Canada's federal government appears to favour a free market model for telecommunications regulation in Canada, as evidenced by its recent decision regarding the regulation of VoIP and local phone services. The relaxation of foreign ownership restrictions on telecommunications and broadcasting companies and the removal or reduction of benefits payments on acquiring control of broadcast licences would likely stimulate acquisition activity.

The proposed changes to the taxation of income trusts will require trusts with media assets to reconsider their corporate structures. Private equity funds may be attracted to these trusts, given their relatively steady cash flow.

Canadian media companies may also feel the need to continue to enhance their online operations to maintain their market share of advertising dollars in the face of competition from Internet players. This may lead to acquisitions in the Internet space—a recent example being the acquisition by Torstar and Gesca (the latter a subsidiary of Power Corp.) of a 100% interest in [workopolis.com](http://workopolis.com).



# 10

## India Will Expand Activity

Greater interest from Indian companies in Canadian M&A transactions is expected, as India continues to look beyond its home market in order to grow, increase value for stakeholders and maintain competitiveness.

Canada-India relations continue to improve and Indian M&A activity in Canada may increase correspondingly, especially following trade missions from officials from both Ontario and Alberta.

While the primary focus of Indian foreign acquisitions will likely be in the energy sector, growth potential for Indian M&A activity also exists in the following sectors: (i) mining, particularly following the October 2006 Indian Mining Mission to Canada; (ii) information technology, as exemplified by recent transactions involving Celestica with HCL Technologies and Aditya Birla Group's indirect acquisition of Minacs Worldwide; and (iii) automotive, with Indian auto manufacturers such as Bharat Forge, Tata Motors and Mahindra & Mahindra looking to gain a foreign foothold.



## Torys' M&A Group

Torys' M&A Group is well-known for its experience in sophisticated, complex and innovative merger and acquisition transactions. We are involved in high-profile mergers and acquisitions, both public and private, as well as those for small and mid-sized companies. On cross-border mergers and acquisitions, we provide seamless service to clients in the United States and Canada.

For more information on our M&A practice, please contact

### Toronto

**Philip Brown**

416.865.8238

[pbrown@torys.com](mailto:pbrown@torys.com)

**Sharon Geraghty**

416.865.8138

[sgeraghty@torys.com](mailto:sgeraghty@torys.com)

### New York

**Richard Willoughby**

212.880.6234

[rwilloughby@torys.com](mailto:rwilloughby@torys.com)

## About Torys LLP

Torys LLP is an international business law firm with offices in Toronto and New York. The firm offers services in mergers and acquisitions; corporate finance; litigation and dispute resolution; restructuring and insolvency; taxation; antitrust and competition; environmental law; intellectual property; energy and power; technology; and other legal services important to major business transactions and cases.

Copies of this and other Torys publications are available on our website at [www.torys.com](http://www.torys.com).

TORYS LLP

NEW YORK TORONTO

237 Park Avenue  
New York, New York USA 10017.3142  
TEL 212.880.6000 FAX 212.682.0200

79 Wellington Street West, Suite 3000,  
Box 270, TD Centre  
Toronto, Ontario Canada M5K 1N2  
TEL 416.865.0040 FAX 416.865.7380

[WWW.TORYS.COM](http://WWW.TORYS.COM)