focus

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FRASER MILNER CASGRAIN LLP

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For over 160 years, Fraser Milner Casgrain LLP has distinguished itself as one of Canada's leading business law firms. With six full-service offices across Canada, and an office in New York, FMC offers the depth of experience and trusted advice to help clients succeed. Depth, Strength, Reach. The FMC advantage in today's competitive business environment. To find out more, visit our websites at www.fmc-law.com or www.fmc-law.us

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We hope you enjoy our newsletter as much as we have enjoyed putting it together. Please contact us at any time to learn more about how you can learn from our professionals. Contact Amy Evans at amy.evans@fmc-law.com to learn more.

COMPLIMENTARY SEMINARS

FMC has an ongoing commitment to bring legal issues affecting business to the business community. Part of this commitment is FMC's series of complimentary seminars. To learn more or to be placed on an invitation list, please contact Amy Evans at amy.evans@fmc-law.com.

FINANCIAL SERVICES September 21

What to Watch for in Intercreditor Lending
Speakers: Tim Bezeredi and Colin Emslie

Securing Intellectual Property Rights
Speakers: Juliet Smith and Taran Atwal

Intellectual Property Rights in Insolvency and the Real Risk
Speaker: John Sandrelli

MINING October 4

Recent Developments for Public Mining Companies
Speaker: Jeff Read

Regulatory Considerations and Project Planning
Speaker: Rick Neufeld

INTELLECTUAL PROPERTY TBA

MINING November 8

Environmental Issues
Speaker: Wally Braul

SPEAKING ENGAGEMENTS

Using BC Limited Liability Partnerships
Speakers: Gordon Funt and Robert Goodrich
Event: Tax Executives Institute (B.C.) September 20

Estates, Trusts and Succession Planning
Speaker: Lori Mathison
Event: CGA-BC Conference 2006 September 20-24

Tax Refresher
Speaker: Lori Mathison
Event: CGA-BC September 28 (Terrace)
November 1 (Nanaimo)

Liability Management for Brownfield Sites
Speaker: Colin McIver
Event: Insight Information: Contaminated Sites Conference
September 28-29

Tax Credits
Moderator: Gordon Esau
Event: FTX West Conference October 12-15

Partnership - Tax Considerations
Speaker: Gordon Funt
Event: CLE Society of B.C. October 19

Corporation Reorganizations
Speaker: Lori Mathison
Event: CGA-BC November 2

An Introduction to Labour Relations
Speaker: Carman Overholt, Q.C.
Event: BC HRMA November 2

Labour Relations, Employment & Privacy Issues in a Hot Mergers & Acquisitions Market
Speaker: Carman Overholt, Q.C.
Event: Insight Information Conference November 27-28

Unchartered Waters: Insolvent Income Trust
Speakers: Gordon Funt and John Sandrelli
Event: Estate Planning Council January 30

Corporation Reorganizations
Speaker: Lori Mathison
Event: CGA-BC February 15

CONGRATULATIONS

Adeline Kong, Michael Larocque and Genevieve Pinto for joining the firm as Associates.

John Sandrelli on his selection as a *LEXPERT Top 40 Under 40* finalist. The Top 40 will be announced on Tuesday, November 14.

NEW FACES

Wally Braul, Consultant

604.443.7148

Wally will further strengthen FMC's ability to offer clients focused and high calibre counsel. His experience and insight will assist our clients in proactively managing environmental and aboriginal issues - particularly those impacting the energy, natural resources and property development industries.

Genevieve Pinto, Associate

604.622.5173

Genevieve is practicing in the areas of securities and corporate/commercial after completing her articles at FMC Vancouver.

Adeline Kong, Associate

604.443.7113

Adeline is practicing in the litigation group after completing her articles at FMC Vancouver.

Michael Larocque, Associate

604.622.5159

Michael has joined the financial services group after completing his articles at FMC Vancouver.

BIOMETRICS IN THE WORKPLACE – WHERE TO DRAW THE LINE?

By Gary Clarke, FMC Vancouver

Biometric technology may sound like something out of a science-fiction novel, but it is increasingly becoming a reality in the modern workplace. Biometric identification uses specific technology to identify an individual on the basis of a unique personal characteristic such as their hand and finger geometry, keystroke dynamics, face or voice recognition, retina or fingerprint. The presence of biometric devices in the work¬place has increased significantly due to the increasing sophistication of such technology, its decreasing cost, post September 11, 2001 security concerns, as well as the need/desire of businesses to operate more efficiently.

Biometric technology is capable of adapting to a variety of employment environments. For instance, an airline could use retina scans to verify the identity of crew members. Similarly, a manufacturer might use a hand scan to prevent "buddy punching", or to know with precision who is where in the workplace in the event of an emergency. ("Buddy punching" occurs when one employee punches in for a late or absent colleague.)

While the benefits of such systems to employers are multiple, many questions remain. What are an employee's right to privacy? How has the employee's right to privacy been balanced with employers' business interests? How do you evaluate a biometric system?

LEGISLATION

In British Columbia, the *Personal Information Protection Act* contains provisions that relate to "employee personal information" and "personal employee information," which impact an employer's implementation and use of biometrics in the workplace.

Employers do not always require the consent of employees before using personal information. For instance, "personal employee information" may be collected, used, or disclosed without consent if the person is an employee or if the information is required for recruitment purposes, provided the collection is reasonable and consists of information that is related only to the employment relationship. Existing employees must be given reasonable notification and must also be notified of its purpose. These provisions provide important exemptions to consent that would otherwise be required (subject to any other available statutory exemptions).

RECENT DECISIONS

Recent decisions on the use of biometric devices in Canada suggest that this technology is here to stay and that employers' business interests will be a factor in determining which technologies get the green light from courts and arbitrators, as demonstrated in the following three examples.

Hand scanning

Hand scanning devices are becoming the preferred punch clock alternative for many employers. A hand scanning device introduced by Canada Safeway for payroll and attendance purposes was upheld in *Canada Safeway Ltd. and United Food and Commercial Workers Union, Local 401*. The determining test was based on proportionality: "the more intrusive the impact on employee privacy the greater the business rationale that must be demonstrated. Conversely, if the intrusion on employee privacy is insubstantial, the concomitant level of justification also is lower".

Voice prints

A similar approach based on balancing interests has been applied to voice print systems. Employers are more likely to get the "go ahead" from courts and arbitrators when they have good evidence to support why the system is both secure and beneficial to business. In *Turner v. Telus Communications Inc.*, for example, the court found that the voice print was "towards the lower end" of the spectrum of privacy intrusion and a reasonable person would see the system as reasonable in the circumstances.

Partial finger scan

Not all biometric systems introduced by employers have stood up to a legal challenge. In *IKO Industries Ltd. and U.S.W.A., Local 8580*, the arbitrator found that the employer could not introduce a partial finger scan because the employees' privacy would be invaded by implementation of the system. The new system was a *want*, rather than a *need*. The employer already utilized additional security, and there was no evidence of security concerns, historical "buddy punching" or past emergency situations to justify the introduction of the biometric system.

LESSONS LEARNED

While the validity of a biometric system in the workplace will, in large part, depend on the individual facts of a case, the above-noted cases provide helpful guidance to employers considering

implementing, discontinuing, revising or improving a biometric system. Furthermore, employers embarking on any of these initiatives should consider the following lessons learned:

1. Define and document the rationale for and benefits of implementing the biometric system.
2. Consider the message a biometric system may convey and its impact on the business. Will it communicate to employees that they are not trusted and adversely impact morale? Or will it provide peace of mind?
3. Consider alternative means to achieve the same result. Perhaps provide an alternative to the system for employees who are uncomfortable with providing biometric information.
4. Collect as little biometric information as possible in the least intrusive way possible.
5. Ensure that biometric information is collected in an open manner. Consult with the union and employees well in advance of the proposed implementation date. (Note that employers with unionized workplaces in British Columbia may have a statutory obligation to give notice of the introduction of a biometric system in accordance with s.54 of the *Labour Relations Code*.)
6. Ensure strict security and safeguards are in place. The less vulnerable the biometric system, the better it will fare before an adjudicator.
7. Develop a written policy that deals with the biometric system. It should explain how biometric data is collected, stored, accessed and used. It should also specify the security controls and safeguards that are in place to protect the integrity of the data.
8. Attempt to negotiate a provision in the collective agreement that expressly gives management the right to introduce biometric systems in the workplace or sets out a process under which this can be done.
9. Ensure that the biometric system does not pose any health or safety concerns.

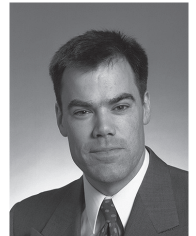
WHAT CAN WE CONCLUDE?

While biometric devices may sound like technology of the future, in reality, such devices are very much a part of the employment environment of the present. Nonetheless, the use of biometrics devices in the workplace poses a number of interesting challenges for employers. Notwithstanding the complexity of the subject matter and the underlying technology, employers seeking to introduce biometric devices in the workplace should attempt to achieve the delicate balance between the employee's right to privacy in the workplace and the employer's right to advance its business interests.

Gary is a Partner at FMC Vancouver. He can be reached at 604.443.7133.

"FAMOUS" TRADE-MARKS

By Peter Cooke, FMC Ottawa



On June 2, 2006 the Supreme Court of Canada released its long-awaited decisions regarding famous trade-marks. One case involved the use of the trade-marks "Barbie", and the other the use of the trade-marks "Clicquot."

The SCC has provided a clear statement about the purpose of trade-mark legislation. While recognizing that many corporations now count famous brand names to be among their most valuable business assets, the Court reaffirmed the purpose of the *Trade-marks Act* – to act as a guarantee of origin, as well as an assurance to the consumer of the quality associated with the mark. The protection granted to "famous" trade-marks is generally assessed on the same principles that are applied to all trade-marks.

BARBIE

In *Mattel, Inc. v. 3894207 Canada Inc.*, an application had been made to register the trademark *BARBIE'S & DESIGN* for a chain of restaurants in Montreal. Mattel opposed the application, arguing that it created confusion with its famous BARBIE trade-marks for dolls and accessories. The SCC unanimously rejected Mattel's opposition, and in doing so, clarified the approach the courts and the registrar should take when considering the issue of confusion.

Test for confusion

In analyzing the likelihood of confusion between the two trade-marks, the SCC considered all the surrounding circumstances, including the factors listed in section 6(5) of the *Trade-marks Act*, namely:

- the inherent distinctiveness of the marks;
- the length of time they were used;
- the nature of the wares, services or businesses;
- the nature of the trade; and
- the degree of resemblance.

These factors need not be given equal weight, and in this case, the Court focused on the distinctions between the wares and services of the parties, as well as the different clientele of the parties. The absence of any evidence of actual confusion was also considered. The Court applied the standard test for confusion set out in section 6 of the *Trade-marks Act* – confusion is to be determined after considering all of the circumstances in their full factual context. The test is the same for famous trade-marks. Notwithstanding all of the above, the Court noted that there need not be an overlap of the wares or services in order to find confusion.

The scope of protection granted to a famous trade-mark will vary. Fame is an additional factor to consider, but the weight given to it depends on the surrounding circumstances. Therefore, while some famous trade-marks may be so well known that their use in connection with any wares or services will likely cause confusion (e.g., *Virgin*), other famous trade-marks may be product specific and entitled to more limited protection (e.g., *Apple* Computers, *Apple* Records, *Apple* Auto Glass).

Survey evidence

Surveys are frequently used in trade-mark proceedings to demonstrate a likelihood of confusion between the trade-marks in question. The SCC noted that for survey evidence to be given any weight in the proceedings, the questions and the survey itself must be:

- relevant to the issue of confusion;
- reliable; and
- valid (e.g., the group surveyed must be sound).

CLICQUOT

In *Veuve Clicquot Ponsardin* v. *Boutiques Cliquot Ltée.*, the champagne company sought to enjoin six women's wear shops in Quebec and eastern Ontario from using the name "Cliquot." The boutiques used the mark "Cliquot" (which was not identical to the VEUVE CLICQUOT trade-mark) on its signs, bags, wrapping, and business cards, but not on the clothing itself.

Test for confusion

As in *Mattel*, the likelihood of confusion is to be determined after considering all the circumstances in their full factual context; the fame of the relevant trade-mark is only one of the surrounding circumstances to consider. In this case, the wares of the parties differed significantly and were sold through different channels. There was no basis for confusion.

Depreciation of goodwill

Section 22(1) of the *Trade-marks Act* provides:

> No person shall use a trade-mark registered by another person in a manner that is likely to have the effect of depreciating the value of the goodwill attaching thereto.

To find depreciation of goodwill:

- The claimant's registered trade-mark must be "used" by the defendant;
- The claimant's trade-mark must be sufficiently well known to have significant goodwill attached to it;
- The claimant's trade-mark must be used in a manner likely to have an effect on that goodwill; and
- The likely effect would be to depreciate the value of the goodwill.

In this case, customers in the clothing boutique would not make a mental link to the VEUVE CLICQUOT mark. Furthermore, the VEUVE CLICQUOT mark was not "used" by Boutiques Cliquot as defined by the *Trade-marks Act*. Veuve Clicquot failed to establish any linkage or depreciation of its goodwill before the Supreme Court, and was unable to prove its case on this point.

WHAT CAN WE CONCLUDE FROM THIS?

Fame is only one factor to consider when determining whether the trade-marks cause confusion. Fame alone does not create a presumption of either confusion or depreciation of goodwill.

These decisions may have dealt a blow to those, such as the International Trade-mark Association, who wished to see the SCC give greater strength and scope to famous trade-marks. However, they may take some comfort from the SCC's finding that in the right circumstances, fame can carry a trade-mark "across product lines" and support a finding of confusion even where the parties' activities do not overlap.

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MEDIATING AND SETTLING MULTI-PARTY DISPUTES

By Susan Griffin, Q.C. and Jacqueline Hughes, FMC Vancouver

While most legal actions involve only a few parties, usually a plaintiff and a defendant, sometimes a single claim includes more than one plaintiff and a host of defendants and third parties. In a construction case, for example, the cause of a dispute cannot easily be attributed to just one party's work because so many parties are involved in design and construction. When a dispute occurs, the result can be a very complex legal proceeding involving the owner, developers, engineers, architects, consultants, general contractors and several subcontractors. The complexity of the issues makes the outcome of any trial of the dispute more difficult to predict, and the number of parties can significantly increase the cost of trial. For this reason, clients involved in litigation are increasingly turning to mediation as a way of resolving the dispute by negotiated settlement. When a negotiated settlement is achieved, settlement agreements must be carefully drafted to protect the parties from any involvement in further litigation.

WHAT IS MEDIATION?

Mediation is a confidential process that involves a meeting or series of meetings between the parties to the dispute, facilitated by a trained mediator who acts as a neutral party to help the parties reach a settlement. The mediator does not take sides, decide any issues in the dispute, or impose a settlement. Rather, it is up to the parties themselves to decide how to settle the dispute. The process is confidential – if no settlement is reached, nothing said during the negotiation can be used against the other party in later court proceedings.

While parties are always free to agree to mediate, in British Columbia one party can force another to mediate. Any party to an action can initiate mediation by delivering a Notice to Mediate under the *Notice to Mediate (General) Regulation*. This regulation applies to many types of actions brought in the Supreme Court, including all types of construction and development-related claims. There is also a process for imposing mediation of residential construction disputes under the *Notice to Mediate (Residential Construction) Regulation*.

In most cases, the parties will jointly appoint a mutually acceptable mediator or, if they cannot agree, a party can apply to have an independent person appoint the mediator. Prior to mediation, a pre-mediation conference will be held, usually by telephone, to address issues such as finalizing pleadings, exchange of documents and other information, and exchange of expert reports. The parties will also agree on a mutually convenient date and location for the mediation session, and working with that date in mind, a timeline for exchange of mediation briefs.

It is important to remember that the formal litigation process continues while mediation is underway. Delivering a Notice to Mediate does not act as a stay of proceedings or otherwise stop the litigation process. However, parties will often adopt a less aggressive approach to the litigation while preparing for the upcoming mediation.

The mediation session takes place after the parties have exchanged all relevant information and mediation briefs. The mediation is usually held at a neutral location, for example a hotel or court reporter's office, and lasts for a full day. However, in some circumstances, negotiations may break down after only a few hours, or may continue by telephone after the mediation session is adjourned.

FULL SETTLEMENT

Ideally, mediation results in a settlement of all issues between all parties, and the parties enter into a settlement agreement drafted by their lawyers, which formalizes the agreement reached at the mediation. It contains the various promises that the parties made, and other terms related to the settlement, such as a confidentiality clause. The settlement agreement usually provides that the parties will execute and file Consent Dismissal Orders, which will have the effect of terminating the litigation.

PARTIAL SETTLEMENT

A more complicated situation arises where only some, but not all the parties, reach a settlement. In these cases, the parties who have settled will enter into a settlement agreement, taking care to protect themselves should the litigation continue against non-settling parties. The settlement documentation allows the plaintiff to continue to seek recovery from the non-settling parties; it also protects the parties who have settled from involvement in the continuing litigation.

WHAT IT MEANS FOR A PLAINTIFF

A plaintiff who has settled with some (but not all) parties will sign a Notice of Discontinuance (as opposed to a Consent Dismissal Order) in favour of the parties who have settled. This has the effect of ending the litigation against those who settled, while still allowing the claim to continue against those who did not.

WHAT IT MEANS FOR A DEFENDANT

Defendants who have settled must ensure that the settlement agreement contains what is known as a "BC Ferries" clause or "Perringer Agreement". In essence, the plaintiff agrees that if the litigation continues, the plaintiff will not seek to recover from the non-settling defendants any portion of the loss that is attributed to the settling defendants. This prevents the non-settling defendants from in turn seeking to recover from the settling defendants, which also prevents the settling defendants from being brought back into the litigation.

Finally, a defendant who has settled will discontinue its claims against any third parties by way of a Notice of Discontinuance. The parties usually agree that no costs are payable by either party.

WHY MEDIATE?

At first glance, it may appear very difficult to settle complex multi-party disputes. However, mediation often helps parties find a mutually agreeable way to resolve their dispute, even where some parties cannot reach an agreement. Parties who want to settle can do so and, with a properly drafted settlement agreement, protect themselves from any further involvement in the litigation.

Susan is a Partner at FMC Vancouver. She can be reached at 604.443.7141. Jacqueline is an Associate at FMC Vancouver. She can be reached at 604.622.5172.

LEAKY CONDOS – THE RIGHTS OF INDIVIDUAL OWNERS

By Joana Thackeray, FMC Vancouver

The "leaky condo" phenomenon has received a considerable amount of attention in the past few years in B.C., particularly around the issue of who can sue whom and the procedural requirements of the *Strata Property Act*. There has long been tension between individual owners, strata corporations, developers, and municipalities. The B.C. Court of Appeal recently clarified the rights of various parties in *Hamilton v. Ball* – a decision that poses new legal challenges for developers and contractors.

CAN INDIVIDUAL STRATA OWNERS BRING AN ACTION?

In this case, the plaintiffs (individual strata owners) claimed that the defendants had caused certain work to be carried out on the common property of a residential strata building without the approval of the strata corporation. They sought damages for defective work done on the common property.

This case was unique because the plaintiffs sought to recover, not on behalf of the strata corporation, but on behalf of themselves as individual owners. But were they permitted to do this? Did they need a resolution from the strata council before proceeding? Ultimately, the Court held that individual condominium owners are entitled to sue third parties for injury to their interests in common property, without the approval of the strata council.

Although s. 171 of the *Strata Property Act* makes the strata corporation responsible for its management and maintenance, and allows it to sue on behalf of all owners on matters involving common property or common assets, until *Hamilton v. Ball* it was uncertain whether an individual strata owner could sue a third party for injury to his or her *own* interests in the common property without involving the strata corporation as a plaintiff and without the approval of the statutory majority.

The B.C. Court of Appeal's decision in *Hamilton v. Ball* was surprising to some as it was previously thought that strata corporations would receive the same treatment as other corporations. That is, they would be subject to one of the most basic principles of company law: when there is damage to a company, *only* the company, and not the individual shareholders, are permitted to seek relief. Similarly, it was previously thought

that the *Strata Property Act* represented a complete code that exhaustively governed strata property ownership. The B.C. Court of Appeal's decision indicates that this is obviously not the case.

In addition to the strata corporation's statutory right to bring an action, the owner also has a right in common law. Since strata owners own common property directly, in proportion to their respective unit entitlements, and since the *Strata Property Act* does not explicitly take away this right, then individual strata owners have a common law right to sue directly for injury or damage to their interests in common property.

WHAT DOES THIS MEAN?

Until this decision is clarified on appeal or by amendments to the *Strata Property Act*, strata corporations and developers must be aware of the possibility of lawsuits brought by individual strata owners for work done on common property. The strata corporation, it seems, may no longer be solely responsible for bringing legal action.

Joana is a Student at FMC Vancouver, and she is currently studying at the University of Victoria Faculty of Law. For further information on this topic, contact Robert G. Nikelski at 604.443.7125.

COMMON LEGAL MISTAKES MADE BY ENTREPRENEURS

By Eric Smith, FMC Ottawa

The entrepreneur's approach to legal issues is often similar to the general population's approach to physical health. Despite consistent warnings that an ounce of prevention is worth a pound of cure, statistics show that the majority of the general population fails to take simple steps that can help avoid serious health problems.

Similarly, many entrepreneurs ignore (or are not aware of) some of the most common, but avoidable, mistakes that can adversely affect the success of their businesses. This article highlights a few of the most common mistakes made by entrepreneurs in the early stages of the planning and operation of their businesses.

MISTAKE #1
OVERLOOKING DUTIES TO PREVIOUS EMPLOYERS

In many cases, an entrepreneur first conceives of his or her new business while an employee of another business, and in some cases will even begin operating the business while still an employee. While there are obvious reasons for doing so (most notably to continue to earn a paycheck while planning the new business) failure to recognize the duties owed to his or her current or former employer can severely hamper the entrepreneur's new business venture.

A careful review of the entrepreneur's current or previous employment relationship, including any letter of hire, employment agreement or other documents signed by the entrepreneur, should be conducted to identify any restrictions that might affect the new business venture. Such restrictions may include:

- assignments of intellectual property rights conceived of or developed by the entrepreneur during the course of employment;
- obligations of confidentiality; and
- non-compete and non-solicitation covenants.

Even where no written agreement exists between the entrepreneur and his or her current or former employer, the common law recognizes certain duties which may apply to the entrepreneur, such as those relating to confidentiality and non-solicitation.

An entrepreneur must also be mindful of these restrictions when recruiting others – such as co-founders, employees or contractors. This is especially critical if a group of employees seeks to start a new business together, particularly if the departure of the group was not welcome news to the former employer.

If an entrepreneur intends to plan the new business venture while still an employee of another business, he or she must be careful not to use the resources of his or her employer for the benefit of the new enterprise. Similarly, the entrepreneur should avoid working on the new business during the hours in which he or she is expected to be performing work duties for the current employer.

MISTAKE #2
FAILING TO IDENTIFY AND DEAL WITH FOUNDER ISSUES

It takes time to plan a new business, and during this time, it is not unusual to seek the input of others. Some of these other individuals may act as casual advisors, while others may be recruited to be co-founders who will be expected to serve a long-term role in the operation of the new business.

Unfortunately, as in all relationships, the expectations of the parties might not be the same, and even when they are, may prove to be unfounded. Failure to clearly identify co-founders and their entitlements can result in a so-called “forgotten founder” reappearing at a critical time for the new venture (e.g., on the eve of a financing) claiming to have a stake in the business or ownership in the new ventures assets (e.g., intellectual property). Even where founders are clearly identified, problems can arise when one or more founders leave the business before making the anticipated contribution to its operation, and in doing so walk away with shares in the corporation that they have not “earned”.

For these reasons, it is important for an entrepreneur and those who assist in the planning of the new business to clearly identify the nature of their relationship. If these individuals will have a role in the conception or development of key assets, such as intellectual property, proper and timely written assignments of intellectual property rights to the new business should be obtained.

If it is intended that these individuals are to receive a stake in the new business (e.g., shares of a corporation formed to operate the business), the parties should consider implementing a vesting schedule pursuant to which the corporation will be entitled to buy-back all or a portion of such shares if the individual does not continue to provide services to the corporation for a specified period of time. In addition, restrictions on the transferability of such shares to third parties, as well as rights of first refusal and drag-along rights should be considered. These type of provisions may be included in a shareholder agreement entered into by all of the shareholders, or may be included in a share restriction agreement entered into between the individual shareholder and the corporation.

MISTAKE #3
FAILING TO PROTECT INTELLECTUAL PROPERTY

While intellectual property is most commonly thought of in the context of the information technology and bio-tech sectors, nearly all businesses are involved, to some degree or another, in the creation and use of intellectual property. These activities may be limited in number, such as the use of a trade-mark and the protection of confidential information, or may include the conception and patenting of inventions that represent almost the entire value of the business. Unfortunately, many entrepreneurs are unaware of the importance of intellectual property until it is too late and effective remedial action can no longer be taken.

While it is not necessary for entrepreneurs to become experts in intellectual property, and it is well beyond the scope of this article to discuss each form of intellectual property, an entrepreneur should have a sufficient understanding of intellectual property, and how it is protected, so that these important assets can be fully exploited.

In addition, entrepreneurs should understand how co-development and other commercial relationships might affect the business' right to use intellectual property. Some of the areas of concern we most often encounter when advising entrepreneurs are:

- the rights of academic institutions to inventions and works resulting from academic research performed for, or in conjunction with, the business;
- rights of government entities, or restrictions on use, resulting from financing and other government assistance;
- rights of other persons resulting from contracting or consulting services provided by individuals involved in the new business; and
- the use of inventions or works that were conceived of or developed jointly with one or more other parties.

MISTAKE #4
NOT SEEKING TIMELY AND EXPERIENCED LEGAL ADVICE

Stating that entrepreneurs should seek out experienced legal counsel in a timely manner may be self-serving, but that does not make it untrue. Many of the pitfalls that entrepreneurs fall into can be avoided if the entrepreneur seeks out information and advice before problems arise. In addition, while financial resources for startup companies are nearly always tight, the cost of proactively dealing with legal issues is often much less expensive than the cost of remedial actions needed to correct problems that could have been avoided.

The key to receiving proper information and advice is to find counsel who has experience working with entrepreneurs and, ideally, experience in the sector in which the new venture will be operating. Experienced counsel will be able to help the entrepreneur focus on those issues that should be addressed immediately, and will also be able to identify issues that should be addressed in the future. In addition, experienced counsel will often have contacts, such as sources of financing or industry contacts,

which can be of assistance to the new venture.

The above are just a few examples of common legal mistakes made by entrepreneurs when planning and operating their businesses. To read more about these topics, as well as many others, please visit www.fmc-law.com/startups where you can download a copy of FMC's publication: *Technology Startups: A Practical Legal Guide for Entrepreneurs, Executives and Investors*.

Eric is a Consultant at FMC Ottawa. He can be reached at 613.783.9632.

INNOCENT ABSENTEEISM AND THE EMPLOYER'S RIGHT TO TERMINATE EMPLOYMENT

By Carman Overholt, Q.C., FMC Vancouver

The law has always recognized the right of an employer to terminate an employment relationship in the labour relations context for what is described as innocent or non-culpable absenteeism. Excessive absenteeism has been recognized as a legitimate and lawful basis for termination of the employment relationship. Arbitrators have held that an employer should have the authority to replace an employee where the employee is unable to work for reasons that are not his or her fault but are outside of his or her control, such as permanent disability.

In determining whether innocent absenteeism may be the basis for termination of employment, Arbitrators have considered whether an extended period of absence is excessive in light of the employment record and the circumstances. Secondly, Arbitrators determine based upon the evidence whether the employee is capable of regular attendance in the future. If it is determined that the absence is excessive and that the employee is unlikely to return to work, Arbitrators have upheld the Employer's decision to terminate employment.

Rod MacRae worked for Interfor for approximately 28 years. In 2002, Mr. MacRae was diagnosed with ALS, an extremely serious illness. He was in receipt of long-term disability benefits and Canada Pension Plan benefits commencing in October 2001. Interfor's Squamish Mill was experiencing severe economic problems and as a result, Interfor decided to close the Mill. It never re-opened. Interfor entered into a voluntary severance agreement with the Union representing the Employees at the Mill. In order to limit the financial cost of closing the Mill, Interfor terminated the employment of Mr. MacRae and 17 other employees for non-culpable absenteeism just prior to entering into the Agreement with the Union under which it agreed to pay voluntary severance to the Employees at the Mill.

A grievance was filed by 18 employees of Interfor, including Mr. MacRae, all of whom were dismissed for non-culpable absenteeism 11 days prior to the Voluntary Severance Agreement being entered into with the Union. Arbitrator Stan Lanyon held that the Employer was justified in terminating the employment of the Employees in light of the fact that they had been absent for extended periods of time and would not in all likelihood return to work in light of the nature of their disabilities. As a result, the Arbitrator dismissed the Grievance.

Mr. MacRae did not accept the Arbitrator's decision and filed a complaint with the BC Human Rights Tribunal. The Tribunal in *MacRae v. International Forest Products Ltd.,* [2005] B.C.H.R.T.D. No. 462 held that the decision to terminate the employment relationship was discrimination on the basis of physical disability. The Tribunal also held that the Employer had not established a bona fide occupational requirement for the decision to terminate. The timing of the termination demonstrated that the intention of the Employer was to avoid having to pay severance costs to the disabled employees. The Tribunal found that the Employer had not acted in good faith and in the result, Mr. MacRae was awarded the severance paid to non-disabled employees, which in his case was approximately $64,000. In addition, Mr. MacRae was awarded $12,500 in compensation for the injury he suffered to his dignity, feelings and self-respect. Interfor did not appeal the decision of the BC Human Rights Tribunal.

Although in theory dismissal for innocent absenteeism continues to be lawful, a careful assessment of the impact of human rights legislation and the duty to accommodate prior to dismissal is necessary. The specific reasons and contributing factors leading to the decision will be subject to scrutiny in the legal proceedings that may arise in these circumstances.

The common law doctrine of "frustration of contract" is available in the non-union context where the evidence shows that the employee is permanently disabled and will not be able to perform the essential duties of the position in the future. A long period of

absence is not sufficient to establish frustration of the employment contract. Although employees have a duty to report to work, an unexplained extended absence will not necessarily establish frustration of contract or abandonment of employment. Evidence establishing that there is no intent or ability to return to work is necessary.

The termination of the employment relationship because of absence or what is viewed as excessive absenteeism may result in a human rights proceeding and wrongful dismissal litigation in the non-union context. Aggravated and punitive damages have been awarded by the Courts as a result of the breach of human rights legislation by employers in similar circumstances. For these reasons, the termination of the employment relationship as a result of absenteeism and disability requires a careful consideration of the evidence and the factors influencing the decision to terminate employment, including the question of whether the employee will return to work. Consideration of other factors such as severance expense may in fact result in a contravention of human rights legislation.

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OIL MONEY FLOWING BOTH DOWNSTREAM AND UPSTREAM

By Stephen S. Poloz,
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Economists apparently can debate endlessly whether high oil prices are due to strong demand, short supply or geopolitical risks. But everyone can agree that oil producers are making a killing.

The average motorist sees the oil market as a wide and increasingly fast-flowing monetary river, with oil-producing nations and companies reaping the spoils. Other sectors of the economy see a steady loss of demand, as consumer purchasing power is diverted to energy spending.

But, as usual, the situation is far more complicated than that. In fact, oil revenues do flow upstream, too. For one thing, Canada has a large energy sector, and a lot of the increased revenues being garnered by oil companies are being ploughed back into investment programs to boost capacity. This is creating employment booms in energy-rich provinces, especially Alberta, and these income streams inevitably flow into most other sectors of the economy, too.

Meanwhile, foreign oil producers will rake in over US$800 billion in revenues this year. If we suppose that the economic price of oil is closer to $50 per barrel instead of $75, implying that current prices include a geopolitical risk premium of $20-25, then the additional transfer of income from oil consumers to oil producers due to this premium is close to $25 billion per month.

And where is this money ending up? Many countries are building oil stabilization funds, with a view to redistributing those funds during future periods of oil price weakness. For example, Norway has a petroleum fund on the order of $200 billion, Kuwait's is over $100 billion and Russia's is around $75 billion. Other countries with smaller funds include Venezuela, Ecuador, Iran and Algeria. Although this amounts to saving, these funds and the associated prosperity in many oil-exporting nations are giving rise to strong growth in infrastructure spending, from power systems, to transportation networks, to water treatment to telecommunications grids.

Accordingly, oil producing countries are importing a lot more from the rest of the world, both in regular consumption and in equipment and services related to infrastructure projects. Looking at the top 16 oil exporters (Algeria, Angola, Indonesia, Iran, Kazakhstan, Kuwait, Libya, Mexico, Nigeria, Norway, Qatar, Russia, Saudi Arabia, Trinidad and Tobago, United Arab Emirates and Venezuela), total imports are likely to reach $800 billion in 2006, up over 25% compared to 2005.

Canada is getting a decent share of the action, with exports to these same countries worth just over US$7 billion in 2005. As for 2006, Canada's goods exports to these countries in April were running at a rate of 37% above last year. Even if these exports moderate through the second half of 2006, as we expect, strong double-digit growth remains likely. Mexico is the biggest Canadian export destination in this group, but Russia, Saudi Arabia, UAE and Algeria are also noteworthy.

The bottom line? Unlike water, oil money flows both upstream and downstream, and Canada is tapping into both flows at this time. Even if oil prices subside markedly as the world economy moderates, these petrodollar flows are likely to persist for the foreseeable future.

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A NEW BUSINESS VEHICLE - LIMITED LIABILITY PARTNERSHIPS

By Gordon Funt, FMC Vancouver

Last year, British Columbia established a new business vehicle by enacting legislation for the creation of limited liability partnerships ("LLPs").

LLPs are common in the United States. In Canada, other provinces have LLP legislation but the legislation of these provinces restricts LLPs to professionals. With business pragmatism, BC's legislature did not restrict LLPs to professionals. As the Minister of Finance stated at the time the enabling legislation was introduced:

> *This [not restricting LLPs to professionals] is in line with US and international practices and will place B.C. firmly at the forefront in Canada.*

NATURE OF AN LLP

What is an LLP? An LLP is a partnership with a special liability protection afforded by statute to its partners. A partnership is defined to mean "the relation which subsists between persons carrying on business in common with a view of profit". To qualify as an LLP, certain statutory requirements (such as registration with the appropriate authorities) must also be met.

SCOPE OF THE LIMITED LIABILITY

In general terms, the liability of a partner of an LLP will be limited to the partner's interest in the partnership and personal liability for that partner's own negligent or wrongful acts or omissions. The partner may also be liable for negligent or wrongful acts or omissions of another partner or an employee of the partnership if the partner knew of the act or the omission and did not take the actions that a reasonable person would take to prevent it.

LLPS AND LIMITED PARTNERSHIPS

BC's legislation also provides for limited partnerships ("LPs"). The liability protection afforded a partner of an LP is greater than that of a partner of an LLP. The liability of a partner of an LP is limited to the capital contributed or agreed to be contributed by the partner to the LP. There is, however, one important qualification. If the limited partner takes part in the management of the business of the LP, the limited partner will lose all protection as a limited partner and will be liable as an ordinary partner (in other words, no protection). The management of an LP is usually undertaken by one partner designated as the general partner. The general partner is not a limited partner.

Unlike the rules for a partner of an LP, the liability protection afforded a partner of an LLP is not lost by engaging in the management of the business of the LLP. Quite understandably, where a partner has contributed significant sums to a partnership, the partner often wishes to be involved in the management of the partnership's business. Affording considerable liability protection while at the same time allowing a partner to be engaged in management is the feature that makes LLPs attractive as a business vehicle.

INCOME TAX AND LLPS

For income tax purposes, LLPs and their partners are subject to the same rules that apply for ordinary partnerships and LPs. Partnerships have two key tax advantages over corporations:

(i) partnerships are treated as flow through vehicles (in other words, there is not a separate level of tax such as that experienced by corporations);

(ii) the income earned through a partnership maintains its character in the hands of the partners (in this regard, often significant tax advantages may be available relative to other business vehicles).

As with all tax matters, complexities are involved. With planning, the complexities can usually be addressed.

DRAWBACKS OF LLPS

A current drawback of a BC LLP as a business vehicle is that other provinces continue to restrict LLPs to professionals. The liability protection afforded to partners of BC LLPs may not be recognized where the LLP carries on business in other provinces. Over time, we expect that the other provinces may follow BC's lead in not restricting LLPs to professionals.

POTENTIAL USES OF LLPS

Since the introduction of LLP legislation in BC, we have seen LLPs used or considered for a variety of purposes. For example, LLPs have been used or considered in real estate development, in estate

planning, and in conjunction with US tax considerations. As the business and professional communities become more acquainted with LLPs, we expect to see LLPs used more frequently.

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THE FEDERAL ACCOUNTABILITY ACT

By Roxanna Benoit, FMC Ottawa

As expected, the first piece of legislation introduced by the new Conservative federal government was the *Federal Accountability Act*. It is now well on its way to becoming a reality, having passed through the House of Commons and awaiting its third reading in the Senate. While the *Act* may represent a symbolic changing of the guard in Ottawa, it is also a substantive legislative initiative that seeks to significantly alter the world of political lobbying and financing.

FINANCING

In June 2003, Prime Minister Jean Chrétien announced his own set of financing reforms. Individual contributions to political parties were limited to $5,000 per year per party, with this limit rising to $5,400 by 2007. Corporations were virtually removed from the picture, being able to donate $1,000 at the riding level, but no longer any amount at the party level. Perhaps most importantly, the financing of federal elections was brought within the public domain, with each vote received by a party receiving at least 2% of all national votes – or 5% of the votes cast in the electoral districts in which a candidate was endorsed by the party – resulting in $1.75 in public financing. As Chrétien stated, "this Bill is one of the most significant democratic reforms to be introduced in a long, long time."

Now the Conservatives will build upon this accomplishment with their own democratic reforms. Perhaps of greatest importance is the complete elimination of corporate or union contributions *at any level*. At the same time, the maximum contribution allowable by individuals will also be lowered. Currently, individuals who are citizens or permanent residents of Canada can give up to $5,000 in total each year to each political party that is registered with Elections Canada. Included in this figure are contributions to a party's candidates, nomination contestants, and registered electoral district associations.

Under the new rules, donations will be limited to $1,000 for individual donations to each registered party, as well as a further $1,000 that can be donated to a party's candidates or electoral district associations. The result of this reform is to lower the effective amount that an individual can contribute to a party in 2007 from $5,400 to $2,000, while ensuring that the money is disbursed among all levels of the party.

While these amendments constitute the major changes to financing proposed by the *Act*, further adjustments aimed at curbing large or inappropriate contributions have also been included in the legislation. For example, the *Act* will require candidates to report any gifts that they receive worth more than $500, and will prohibit candidates from accepting gifts that might reasonably be seen as influencing them in the performance of their elected duties. Parties will also be barred from receiving cash donations in excess of $20.

LOBBYING

In addition to its impact on political financing activities, the *Federal Accountability Act* makes several major amendments to the *Lobbyists Registration Act*, including a name change. The scope of the *Lobbying Act*, as it will soon be known, remains generally unchanged relative to the pre-amendment *Act*. This comes as no surprise to lobbyists, who saw the definition of "lobbying" substantially widened by the Martin government in 2005. Those amendments saw the type of behaviour captured by the *Act* change from "communications in an attempt to influence" to merely "communications." As such, any communication with a federal public office holder is considered lobbying and gives rise to a registration requirement if it relates to the activities outlined in the *Lobbying Act*.

Examples of registrable activities include communications with respect to the development of a federal legislative proposal, the introduction or amendment of a federal Bill or resolution, and the making or amending of any federal regulation, policy or program.

Even if the *Federal Accountability Act* does not further broaden the definition of lobbying, its effect on lobbyists should not be underestimated. The new *Lobbying Act* will ensure that lobbyists face more demanding compliance requirements, tougher penalties, and a more empowered enforcement mechanism. It all adds up

to a significant reform on lobbying as promised.

The amended *Lobbying Act* would see a ban on contingency fees and the creation of a new Commissioner of Lobbying, who would be charged with overseeing the enforcement of the *Lobbying Act* provisions. New investigative powers would include the ability to follow-up with public office holders in order to verify information reported by lobbyists. Financial penalties allowable under the *Act* will be doubled, with maximum fines of $200,000 for making false or misleading statements, and $50,000 for other contraventions of the *Act*. Making false statements could also carry a sentence of up to two years imprisonment, if brought by way of indictment.

The change that will arguably have the greatest impact on lobbyists is a change to the actual filing requirements imposed by the *Act*. Under the current *Act*, lobbyists are required to file a return every six months after initially registering their lobbying activities. The new *Act* will add an additional filing requirement calling for monthly reporting of all communications where ongoing lobby work continues. Where no communication occurs, bi-annual filings are still required until the undertaking in question has been performed or terminated, in the case of consultant lobbyists, or the organization has ceased to employ staff undertaking lobbyist activities, in the case of in-house lobbyists.

The *Federal Accountability Act* may amend the format of some filings, but the trigger for registering and the content of the filings remains generally the same. Corporations and organizations will be required to submit two lists of employees with their initial registration – one list containing the names of all senior officers or employees who dedicate a significant part of their duties towards lobbying activities (defined as 20% of their working time or greater), and a second list containing the names of each other senior officer who commits *any* of their working time towards lobbying.

The filing will also need to include particulars identifying the subject matter that is communicated, the department or institution of any public office holder that may be communicated with, and even information regarding the communication techniques to be employed. Further, if any employee is a former public office holder, then the filing must describe the offices held and the date upon which the employee ceased to hold that office. Of course, such former public office holders should consider themselves fortunate, as their more contemporary counterparts who leave *senior* public office positions or government transition teams will face a five-year ban from all lobbying under the amended *Lobbying Act*.

While this article can only begin to touch on the changes resulting from the *Federal Accountability Act*, it provides some insight in the new world of political financing and lobbying that will, pending developments in the Senate, be ushered in within the next year.

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SECOND LIEN SUBORDINATE FINANCING

By Tim Bezeredi, FMC Vancouver

Businesses are increasingly using second lien lending to finance acquisitions, restructurings and management buyouts. As such, a clear understanding of their features and benefits is important when evaluating this tool. In addition, awareness of issues that arise in preparation of intercreditor agreements will aid lenders and borrowers when collaborating with senior and subordinate lenders.

Second lien lending (credit backed by the assets of a borrower) arises from the premise that the asset value or enterprise value of the borrower's business supports indebtedness in excess of traditional senior debt. The middle tier of the capital structure, historically filled by mezzanine debt, has become an active segment of the financing market. The traditional three tier structure of senior debt, mezzanine and equity has evolved into a much more complicated multi tiered structure of senior debt, junior or second lien indebtedness, traditional mezzanine and equity.

Second lien financing is particularly attractive to asset rich enterprises. Second lien loans, originally employed as rescue capital, were historically structured as asset based loans using tangible asset values. However, as their popularity increased, second lien loans are now more commonly underwritten on a cash flow basis, with increased risk to lenders on default. Because of the increased prevalence of second lien lending, many overleveraged distressed companies with little collateral or debt capacity to finance reorganization may be moved toward a liquidation scenario rather than a successful reorganization.

Second lien loans may in fact limit the ability of distressed companies to restructure and reorganize. The increased levels of secured debt may make it more difficult for companies under creditor protection to operate, and could force struggling

companies to liquidate rather than restructure.

FEATURES OF SECOND LIEN LOANS

Second lien lenders are able to attribute value, and secure their loans against non-traditional collateral. In a second lien loan transaction, the second lien lender holds a second or lesser priority security interest on the assets of the borrower. Secured second liens are generally structured in one of two ways. The most prevalent way is for the senior lien to be secured against all of the available assets while the second subordinate lien relies on incremental dollars against the same collateral pool. In the other, less common circumstance, the first and second liens are secured by separate pools of collateral. It is a way for the borrower to tap into the equity of the company's assets. Second lien lenders are able to attribute value and secure their loans against non traditional collateral classes such as royalties and intellectual property, including trade-marks.

The second lien lender's security interest ranks second in priority to the liens on those assets securing the first priority lien debt. In the event of realization on the security against the shared collateral, the first lien secured creditor is entitled to be paid in full from the realization proceeds before any payments are made to the second lien secured lender out of those proceeds. In terms of priority, the second lien lender ranks ahead of any unsecured subordinated debt and also in front of contingent liabilities and trade payables.

The senior lender usually requires, by way of an intercreditor agreement, that the second lien lender agree to restrictions on its ability to enforce the second lien security and to receive payment under the junior facility in circumstances where the senior facility is in default.

Second lien lenders are willing to take the increased risk because the potential return is greater. Interest rates on second lien subordinate loans are anywhere between 10% and 15% or greater on an annualized basis.

The following primary requirements generally must be met in order for subordinate second lien lenders to consider an investment:

1. The borrower must have an experienced management team with depth at all levels.
2. The management team and owners must have a strategic plan or vision that is easily understandable and readily achievable given the company's capabilities and resources.
3. The company must have a demonstrated history of predictable cash flow indicating that interest payments will be made on the subordinate debt.
4. There should be a projected substantial increase in the value of the company as a result of the execution of management's plan. (This is the reward for the higher risk assumed by the subordinate lender.)

SECOND LIEN VS. MEZZANINE FINANCING

Second lien lending can provide greater flexibility to a borrower than traditional mezzanine financing.

The term "mezzanine financing" can be used to describe any financing that is below senior debt but above common equity and senior debt. The term usually applies to unsecured financing, which is primarily a loan but which relies on an "equity kicker" to boost the return on the loan to compensate for the greater risk inherent in a subordinate unsecured loan. The equity kicker can be structured as share purchase warrant, as a right to convert all or part of the loan into common shares, as a success fee, or as an upfront equity interest in the form of preferred or common shares.

Increasingly, borrowers are taking advantage of second lien loans as an alternative to mezzanine financing. Some attractive features of second lien financing are:

- It is sometimes more flexible than mezzanine and other junior capital, while creating additional liquidity for the borrower.
- It is typically less expensive than mezzanine or equity based capital, and is often non dilutive to the borrower.
- Lenders will generally offer terms and pricing that are more flexible than those of an unsecured mezzanine provider, and are less onerous in terms of prepayment penalties.
- The debt generally has a shorter term of three to five years, versus seven to ten years for mezzanine loans, although second lien loans are often structured with longer terms.
- It usually provides more borrower-friendly prepayment

- options, sometimes allowing the borrower to make periodic prepayments from excess cash flow.
- The pricing is attractive. Rates are typically significantly less than the traditional 15% to 20% mezzanine returns. Even more importantly, second lien lenders will not always require warrants or some other form of "equity kicker" so the borrower does not have to relinquish any equity.

INTERCREDITOR AGREEMENTS

Senior lenders will try to relegate second lien securities to a "silent second" position through payment blocks and standstill agreements.

Senior lenders typically want to retain control over common collateral by requiring the junior secured lender to enter into an intercreditor agreement that relegates the junior to a "silent second" lien. Senior lenders will also want to ensure maximum flexibility to administer and dispose of collateral with minimal interference from the junior lender.

A standard set of terms for intercreditor agreements between senior and junior lenders has yet to emerge. The following is a summary of material terms and issues which arise in the preparation and negotiation of intercreditor agreements between senior and subordinate lenders.

Priority provisions

The primary feature of the intercreditor agreement is the subordination of the junior lender security to the senior lender security. The junior lender can sometimes successfully negotiate a priority for itself over specific assets of the borrower (e.g., intellectual property and goodwill).

Payment blocks

The second lien lender will usually accept some level of debt subordination, agreeing that its right to receive payment on its debt may be suspended upon the occurrence of certain events or conditions.

Standstill provisions

Unlike an unsecured mezzanine loan in which mezzanine lender remedies are generally limited to commencing action against the borrower for recovery of the debt or initiating bankruptcy proceedings, the second lien lender has the additional right to enforce its security in the collateral. The second lien lender must usually grant the senior lender a covenant not to enforce the second lien security for a specific period of time (i.e., a standstill period).

Release of junior liens in asset sales

For asset sales in the ordinary course of the borrower's business (as opposed to the sale of substantially all of the assets), the second lien lender usually consents in advance to the release of its liens.

Bankruptcy waivers

The second lien lender is sometimes required to grant consents and waivers in the event the borrower files for protection from its creditors under the *Bankruptcy and Insolvency Act* or the *Companies Creditors' Arrangement Act*. These waivers generally include the right to oppose adequate protection, and advance consents to the use of cash collateral, sales of collateral and debtor in possession ("DIP") financings.

A trend has emerged for the second lien lender to give up or limit its right to vote on a proposed plan of reorganization. The enforceability of intercreditor agreements restricting bankruptcy voting rights of a junior lender remains in question.

Equity participation

In private company financings, secured subordinate lenders will often acquire an equity interest in the borrower that, together with the lender's exit strategy, will achieve the desired rate of return.

Anti-dilution protections

An important consideration to subordinate lenders with equity participation is the percentage of the company that the lender will own on a fully diluted basis (i.e., the total number of issued common shares plus all other common shares, which would be issued upon exercise and conversion of all outstanding options, warrants, convertible preferred shares and convertible debt). The subordinate lender will protect its ownership percentage through the use of pre emptive rights, anti dilution protection and price protection.

Governance

The subordinate lender with an equity interest may expect representation on the company's board of directors. Board representation allows the lender to review all important managerial

decisions and to participate in all decision-making that occurs at the board level. To mitigate the risks of lender liability and the directors' duty of care, lenders may stipulate for observer status rather than full board representation.

Veto rights

As minority shareholders, subordinate lenders will generally expect to have a right of approval in relation to a variety of matters that are important to the capitalization, growth, financing and management of the company. The lender's approval is usually given either by the favourable vote of the lender's representative on the board of directors or through the approval of the lender in its capacity as shareholder.

Pre-emptive rights

Subordinate lenders typically insist on having pre-emptive rights to protect themselves against dilution from future share issuances. The company generally prefers to grant the lender pre emptive rights rather a complete prohibition against share issuances without the lender's consent. Pre emptive rights give the lender the right to purchase, out of shares to be issued by the company from treasury, its *pro rata* share of such securities.

Right of first refusal

The investor agreement will typically include a right of first refusal allowing shareholders to purchase their *pro rata* portion of shares that are offered by any selling shareholder to a third party, at the price and on the terms that have been offered by the third party.

Tag-along rights

Where a shareholder has successfully negotiated the sale of its shares to a third party, tag along rights require that other shareholders be permitted to sell their shares to the purchaser (i.e., to "tag along" with the majority shareholders) on the same terms and conditions.

Drag-along rights

Drag along rights, which are common in shareholders agreements, permit majority shareholders to negotiate the sale of the company to a third party and then compel (or "drag along") the minority shareholders to sell their shares to the third party on the same terms and conditions that have been agreed to by the majority shareholders.

Put rights

The subordinate lender may insist on "put" or redemption rights to achieve liquidity if it is not available through a sale or public offering. It gives the lender the right to require the company to repurchase the lender's shares on the earlier of any number triggering events.

Usury issues

Section 347 of the *Criminal Code* makes it a criminal offence to enter into an agreement or arrangement to receive, or to actually receive, "interest" on credit in excess of 60% per annum of the total value of the credit advanced. Two decisions of the Supreme Court of Canada have heightened the uncertainty created by section 347 regarding subordinate loans with equity participation in the form of upfront equity interests, share purchase warrants, and convertible debt.

CONCLUSION

In conclusion, second lien subordinate financing is becoming increasingly prevalent in the middle tier of the capital structure. Great care must be taken to properly understand and document the subordinate lender's relationships with its borrower and the senior lender due to the subordinate status and frequent preference of an equity component to achieve the lender's desired rate of return.

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