

focus

on Venture Capital



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Cross-Border Financing Issues

This update has been prepared primarily for the benefit of U.S. investors and their advisors, as well as Canadian technology companies seeking venture capital financing from U.S. sources.

Although financing activities and valuations declined from 2000, venture capital and private equity investment in Canada did not experience the dramatic downturn in 2001 that occurred in the United States. This was due in large part to foreign investor groups (primarily U.S. venture funds and corporate investors) who, despite the current market slowdown, demonstrated heightened enthusiasm for financing opportunities in Canada. While forecasts vary as to when the North American economy will improve for technology companies, it is clear that U.S. investors are increasingly looking north for investment opportunities.

In acting for issuers and investors in numerous cross-border venture capital financings, we have observed a convergence in the legal documentation used by U.S. and Canadian counsel. However, in a number of areas, U.S. investors and their advisors cannot assume that Canadian laws will parallel laws in the U.S. The purpose of this update is to highlight some of the key differences.

This update will cover the following topics:

1. Advantages and disadvantages of incorporating in Canada.
2. Recent changes to Ontario securities legislation relating to exempt offerings.

3. Cross-border registration rights issues.
4. Recent changes to the *Canada Business Corporations Act* (the "CBCA").
5. Equity incentive plans for Canadian executives, employees and consultants - compliance with Ontario securities laws.
6. Debt financing transactions - criminal rate of interest issues.
7. Employment law issues.

We also direct readers to "*Doing Business in Canada*", our comprehensive publication for U.S. and foreign clients, which is available on our web site.

This update is intended to be general in nature and is not exhaustive. On the last page we list contacts in each of our offices across Canada who would be pleased to discuss these issues in more detail.

ADVANTAGES AND DISADVANTAGES OF INCORPORATING IN CANADA

U.S. investors are increasingly aware of the risks – including potential adverse tax consequences – of investing in entities organized outside of the United States. In many cases, legal advisors have responded by recommending that Canadian start-ups incorporate in the U.S. Sometimes, U.S. incorporation is the right decision for both the company and its investors. However, there is no "one size fits all"

answer. This article explores some of the advantages and disadvantages of incorporating in Canada and/or investing in Canadian corporations. (Note that most U.S. businesses with operations in Canada will incorporate a Canadian subsidiary for the purpose of conducting operations in Canada; similarly, most Canadian corporations operating in the U.S. will have a Delaware subsidiary. This article deals with the jurisdiction of incorporation decision for the parent corporation.)

Advantages of Incorporating in Canada

CCPCs

A “Canadian - controlled private corporation” (CCPC) is a private corporation which is not controlled, directly or indirectly, by non-residents and public corporations (or any combination of non-residents and public corporations). “Control” is not merely a question of voting control or ownership of a majority interest in the corporation - it is a matter of actual influence on the day-to-day management of the corporation, whether through share ownership, a stockholders agreement, option to purchase shares or other means. A CCPC must be incorporated in Canada.

The best reason to incorporate in Canada is to secure the numerous benefits of CCPC status, if the company could otherwise qualify as a CCPC. These benefits, which are summarized below, are well known to Canadian tax and legal advisors.

1. Capital Gains Deduction. Only shares of a CCPC can qualify as “qualified small business corporation shares” (QSBC shares). The first Cdn.\$500,000 of capital gains earned by an individual (other than a trust) on the sale of QSBC shares will not be subject to income tax. This can be a significant benefit for Canadian founding shareholders, especially if share splitting with a spouse or other individual is used as a tax planning strategy. Note that this is a “lifetime” exemption, and if already fully used, will not be available for the sale of QSBC shares.

2. Reinvestment Opportunities. In February 2000, the Canadian federal government introduced a tax deferral of capital gains for proceeds of up to Cdn.\$2,000,000 resulting from the sale of shares of an eligible small business corporation (which must be a CCPC on the date of the sale) if the proceeds are reinvested in another CCPC. The deferral is subject to certain restrictions on the carrying value of the assets of the second CCPC both before and after the transaction. Unlike the corresponding U.S. capital gains reinvestment scheme, the deferral is only available to individuals and cannot be “passed through”

professional investment corporations, trusts or partnerships.

3. Tax Deferral on Exercise of Stock Options for Canadian Employees. As a general rule, an amount equal to the “in-the-money” value of employee stock options will be included in the income of a Canadian employee in the year of exercise and reported on his or her T4. However, on the exercise of an option of a corporation which is a CCPC on the date of grant, tax is deferred until the taxation year in which the employee disposes of the underlying shares. There is also a deferral available for shares of a corporation which is not a CCPC – however, the deferral is limited (to an annual maximum of Cdn.\$100,000 based on the fair market value of the underlying shares on the date the option was granted) and is only available for shares listed on a prescribed stock exchange. If no deferral is available, a Canadian employee who exercises a stock option and fails to dispose of the underlying shares in the same taxation year will not have realized cash proceeds to cover the resulting tax liability.

4. Tax Deduction on Gain from Optioned Shares. Where an employee stock option benefit is included in the income of a Canadian employee, the Income Tax Act (Canada) (the “ITA”) provides for two separate fifty percent deductions (if available, either deduction, but not both, may be claimed):

(a) CCPCs. Where an employee stock option is granted by a CCPC to an employee, a fifty percent deduction will generally be available if the employee does not dispose of or exchange the shares within two years of acquiring the shares under the stock option.

(b) Non-CCPCs. The second fifty percent deduction is available to employees whether or not the stock option was granted by an employer corporation that was a CCPC at the time of the grant, but is subject to two conditions. First, the exercise price of the option must be not less than the fair market value of the shares at the date of the grant. Since shares of private companies are notoriously difficult to value, the “fair market value” strike price requirement has caused difficulties for non-CCPCs. Moreover, we advise our company clients that the Canada Customs and Revenue Agency (CCRA) is not bound by a board’s “good faith” determination of value. While a similar “fair market value” requirement applies to ISOs which may be granted to U.S. employees, it is not uncommon for the CCRA (unlike its U.S. counterpart) to challenge fair market value determinations where the value of shares appears to be understated. For this reason, Canadian advisors tend to recommend a conservative approach to option pricing, which in our experience can result in frustration for boards of corporations which need to recruit employees on both sides of the

border. The second condition of this deduction is that shares must be “prescribed shares” within the meaning of the ITA. The definition in the ITA appears to be intended to reflect “garden variety” common shares. However, the definition is lengthy and complex – for instance, a right of first refusal in favour of the employer must be carefully tailored or the “prescribed share” definition will not be satisfied.

As a bottom line, CCPCs can exercise greater flexibility in structuring equity incentive plans (such as the ability to grant “cheap” or below-fair market value options) without depriving Canadian employees of an important tax deduction.

5. **Investment Tax Credits.** Investment tax credits (ITCs) under the Scientific Research and Experimental Development (SR&ED) program lower the cost of SR&ED performed in Canada. Generally, SR&ED expenditures are fully deductible or may be carried forward indefinitely. ITCs under the SR&ED program are available to both CCPCs and non-CCPCs. However, CCPCs are eligible for special treatment. If a corporation is a CCPC through the year with Cdn.\$200,000 or less of taxable income in the previous year, it can receive an ITC equal to thirty-five percent of certain qualified SR&ED expenditures subject to an expenditure limit of Cdn.\$2,000,000. For CCPCs, this is a refundable claim - meaning that to the extent that the corporation does not otherwise have to pay tax, it may be entitled to a full refund on qualified current expenditures, and a forty percent refund on qualified capital expenditures. For non-CCPCs, the ITC rate is twenty percent for both current and capital expenditures and claims are not refundable (that is, the corporation can only apply the claim against tax otherwise payable). The refundability feature available only to CCPCs can be an important source of cash flow for early-stage companies, potentially providing months of additional runway before seed or venture capital funds are exhausted.

6. **Small Business Deductions.** CCPCs earning income from an active business carried on in Canada are eligible for the small business deduction, which lowers the federal tax rate on the first Cdn.\$200,000 of active business income to approximately thirteen percent (about nine percent less than the general corporate rate). Before anticipated reductions to the general corporate rate take effect, CCPCs also have the benefit of a somewhat lower rate of federal tax on active business income between Cdn.\$200,000 and Cdn.\$300,000.

7. **Deduction of ABILs.** An individual who lends money to a CCPC (whether in the form of convertible or non-convertible debt) is permitted to deduct an allowable business investment loss if the debt is ultimately written off. This can be a benefit to bridge or angel investors who

prefer to invest in a debt vehicle.

Canadian Companies which are not CCPCs

Even if a company cannot qualify as a CCPC, there are still reasons to consider incorporating in Canada:

1. **Access to Capital.** Certain large pools of capital are only available to companies incorporated in Canada. Business Development Bank of Canada (BDC) and Ontario labour-sponsored venture capital corporations are only permitted to invest in entities organized under Canadian laws. While it is possible for some restricted investment funds to invest indirectly in a U.S. incorporated entity (for instance, by purchasing exchangeable shares of a Canadian subsidiary), this results in a complicated capital structure and extra expense to both the company and the investor. The investor at the Canadian subsidiary level may also encounter tax problems if the company is acquired by a U.S. purchaser (see “No Roll-over Treatment for Canadian Shareholders” below).

2. **Eligibility for RRSPs.** Shares of a private Canadian corporation can be “qualified investments” for the purpose of certain deferred income plans including registered retirement savings plans. Unlisted shares of a U.S. corporation cannot be “qualified investments”. This means that shareholders of eligible private Canadian corporations can allocate shares to a RRSP or similar plan, where the investment can grow on a tax-sheltered basis. Employees can also use funds held in a RRSP to purchase an equity interest in an eligible private Canadian corporation through an employee share purchase plan.

3. **Lower Legal and Accounting Costs.** U.S. incorporated companies operating primarily in Canada must comply with two separate tax and securities regulatory regimes. This means that companies must regularly consult both U.S. and Canadian legal advisors and accountants. As a result, Canadian businesses which incorporate in the U.S. often have significantly higher expenses for day-to-day professional services.

Disadvantages of Incorporating in Canada

Again, tax considerations on both sides of the border weigh heavily in the decision to incorporate in the U.S. rather than Canada. Note that most of the factors weighing against Canadian incorporation only become important at the time of a merger or acquisition or other liquidity event.

1. **No Roll-over Treatment for Canadian Shareholders.** A common

exit for many successful Canadian businesses, particularly in the technology sector, is a purchase by a U.S. acquiror. However, Canadian shareholders do not receive a roll-over in the event of a purchase of shares of a Canadian corporation in which the purchase price is stock of a U.S. acquiror. As a result, tax will be payable by Canadian shareholders on the gain in the value of their shares in the year of the sale, rather than the year in which they dispose of the stock received on the acquisition. In all-stock or cash-and-stock deals in which shares of the U.S. acquiror are not immediately freely tradeable, this means that the Canadian shareholders will likely not have sufficient cash proceeds (or any cash proceeds) from the sale to cover the resulting tax liability. This issue is particularly serious for Canadian selling shareholders of Canadian corporations if there is no public market for the shares of the U.S. acquiror, or if the shares received on the acquisition are subject to resale restrictions. This problem can be addressed by the U.S. acquiror issuing exchangeable shares of a Canadian subsidiary, which are directly or indirectly exchangeable for shares of the U.S. parent, to Canadian shareholders of the target company. Most cross-border practitioners are now familiar with this type of exchangeable share transaction. However, compared to a conventional acquisition, an exchangeable share structure is costly and time-consuming. Exchangeable share structures also create their own securities and tax problems, and at the end of the day Canadian shareholders who receive exchangeable shares may not have the same degree of liquidity as their U.S. counterparts. The CCRA is aware of this issue, and in November 2000 introduced a proposal to make roll-over treatment available in share-for-share take-overs of unlisted Canadian corporations. To date, we have not seen action on this proposal and as such we are not expecting its formal adoption in the foreseeable future. If an acquisition by a U.S. entity is anticipated, founders may be advised in the first instance to incorporate in the U.S., since roll-over treatment is available for Canadian shareholders of a U.S. corporation acquired by a U.S. entity.

2. Withholding Tax on Proceeds of Disposition of Non-Residents. In an acquisition of shares of a Canadian corporation which are not publicly traded, twenty-five percent of the proceeds of disposition payable to a non-resident seller must be withheld by the purchaser to cover the potential tax liability of the seller. The purchaser is relieved of this obligation if the non-resident seller obtains a clearance certificate (otherwise known as a Section 116 certificate) from the CCRA. A clearance certificate is readily obtainable from the CCRA if the non-resident seller prepays Canadian tax (or provides acceptable security) on the capital gain arising from the sale transaction. A clearance

certificate should also be available where the sale of shares is exempt from capital gains tax in Canada pursuant to the Canada-U.S. Income Tax Convention (the "Treaty"). However, if a clearance certificate is requested based on a Treaty exemption, there are often delays while the CCRA reviews relevant tax information to confirm that a Treaty exemption is in fact available. If a clearance certificate is not obtained within a month of the closing of the transaction, the proceeds withheld by the purchaser must be remitted to CCRA. However, in some districts (for example, the Ottawa region), there can be a delay of up to twelve weeks before requests for clearance certificates are processed. If proceeds are shares of a publicly-traded acquiror, non-resident sellers will be exposed to fluctuations in the equity markets during the waiting period. Note as well that in the case of non-resident sellers structured as limited partnerships, the CCRA may require detailed tax information regarding the limited partners in order to determine if a Treaty exemption is available. In our experience, this has caused administrative problems and privacy concerns for non-resident investors.

3. Loss of Flow-Through Status for LLCs. The benefits of the Treaty are not available to limited liability companies (LLCs) by virtue of their flow-through status for U.S. tax purposes. As a result, any gain (or loss) from the sale of shares of a Canadian corporation will be fully taxable in Canada and will not be flowed through to shareholders of the LLC. As a result, it is generally not viable for LLCs to invest directly in Canadian corporations, although an indirect investment through a Barbados holding structure is a possibility (provided that the LLC is willing to establish such a structure, usually at its own expense).

4. Withholding Tax on Dividends and Deemed Dividends. A Canadian corporation will also have withholding and remittance obligations with respect to dividends and deemed dividends payable to non-resident shareholders. A deemed dividend may arise on the redemption or other repurchase of shares by a Canadian corporation to the extent that the proceeds to the shareholder exceed the paid up capital of the redeemed shares. The withholding rate applicable to dividends and deemed dividends is either five or fifteen percent, depending on the payor's percentage ownership of the corporation.

5. U.S. Tax Issues. The discussion above touches on selected issues arising under Canadian tax legislation and treaties which impact U.S. investors investing in Canadian companies.

There are also several provisions of U.S. tax law that may result in unfavourable U.S. tax treatment of a disposition by a U.S. shareholder of an interest in a Canadian corporation. If the Canadian corporation is treated as a controlled foreign corporation, passive foreign investment

company, or a foreign investment company, gain recognized by a U.S. shareholder in a taxable sale may be taxed as ordinary income.

Moreover, the U.S. will tax many dispositions of foreign shares by U.S. shareholders in transactions that would qualify for nonrecognition as a tax-free reorganization had the U.S. shareholder disposed of U.S. stock. For example, transactions that involved the merger of a Canadian corporation into a U.S. corporation will be taxable to the Canadian corporation's U.S. shareholders even though the merger would have been tax-free for two U.S. corporations. As a further example, an asset sale by a Canadian corporation to a U.S. corporation in exchange for stock, that normally would be treated as a tax-free reorganization under U.S. tax law, will generally trigger taxable income for U.S. shareholders who own ten percent or more of the Canadian corporation's shares to the extent of their share of the Canadian corporation's earnings and profits. In this situation, a tax-free result can be achieved if, instead of acquiring the Canadian corporation's assets, the U.S. corporation acquires shares in the Canadian corporation by issuing its voting stock in exchange. In any event, care will be required in structuring a U.S. shareholder's disposition of shares of a Canadian corporation.

Deciding Where to Incorporate

In general, Canadian incorporation may be preferable in the following situations:

- the controlling shareholder group is such that the company would be able to qualify as a CCPC;
- the company anticipates that it can fund its operations and execute on its business plan without having to seek venture capital from U.S. sources;
- BDC or a labour-sponsored fund will be a lead investor at an early stage; and/or
- the company is a smaller venture that cannot afford the extra expense of U.S. incorporation.

On the other hand, U.S. incorporation may be preferable if:

- the company will be controlled by non-residents and/or public companies such that the company would not otherwise qualify as a CCPC;
- a principal lead investor is a U.S. LLC or a U.S. LLP (particularly if the general partner of the U.S. LLP is itself an LLC);

- the anticipated exit for the company is an acquisition by a U.S. purchaser; and/or
- as the company matures, it anticipates shifting its operations south of the border.

U.S. tax issues which are not particular to investments in Canadian corporations may also impact the decision if a U.S. investor is involved.

For many early-stage Canadian technology companies, the jurisdiction of incorporation decision will be a factor of the relative bargaining strength of the Canadian founders (who will generally prefer Canadian incorporation) and prospective U.S. investors (who tend to prefer U.S. incorporation).

If a company would otherwise be a CCPC but for U.S. incorporation, it may wish to establish a "sister" Canadian company that will qualify as a CCPC for the purpose of obtaining refundable SR&ED credits at the enhanced rate.

As a final note, it is possible to export a Canadian corporation to the U.S. Generally, an export results in shareholders being deemed to have disposed of their shares, resulting in a capital gain. The deemed disposition can be avoided if the corporation adopts an exchangeable share structure. The difficulty of tax issues in both Canada and the U.S. means that exports are rarely undertaken.

RECENT CHANGES TO ONTARIO SECURITIES LEGISLATION RELATING TO EXEMPT OFFERINGS

In our December 2001 *Focus on Securities – Exempt Distributions and Resale Rules* (accessible on our web site), we overviewed recent changes to the *Securities Act* (Ontario) and related rules which substantially revised the Ontario private placement exemptions available to issuers. These changes attempt to assist the capital formation process for small and medium-size businesses. In addition to eliminating the problematic "private company" and "seed capital" exemptions, the minimum Cdn.\$150,000 private placement exemption was also removed. New exemptions (under revised OSC Rule 45-501) are an "accredited investor exemption" (similar to the approach taken under Regulation D in the U.S. but with tests denominated in Canadian dollars), and a "closely-held issuer" exemption for early-stage issuers. Also new are changes to resale rules under Multilateral Instrument 45-102, which will mandate legends for the first time on certain securities in order to take advantage of resale exemptions.

New exemptions were also recently introduced in Alberta and British

Columbia. However, in Quebec rules are not expected to change, and as a result concepts of minimum investments and "private company" investments will continue to be important.

Readers are reminded that, unlike the U.S. where in recent years federal securities laws have in many instances pre-empted state securities laws, securities laws in Canada are predominantly regulated on a provincial basis. Although there is a fair level of conformity in the securities laws of the various provinces, distinctions remain, and it is important to be aware of applicable rules in the province(s) in which trades will take place.

CROSS-BORDER REGISTRATION RIGHTS ISSUES

While the "menu" of registration rights involving only U.S. issuers and U.S. investors has become fairly straightforward, the negotiating points for a cross-border venture capital financing can be considerably more complex.

From the perspective of a U.S. investor in a Canadian business, the challenge will be to ensure that, in addition to securing the customary U.S. registration rights, the investor is properly protected in the event that the company chooses to do an IPO in Canada alone or as part of a cross-border offering. Two issues come into play - first, whether statutory resale restrictions will be imposed on the investor, and second, whether the investor will be captured by a statutory escrow regime on an IPO.

In terms of resale restrictions, while there are similarities between the Canadian and U.S. approach, there are also fundamental differences. In the U.S., the Rule 144 holding period starts from the time that shares are issued to the investor and ends after the applicable hold period, assuming that necessary public financial information is available and volume restrictions are not exceeded. In Canada, resale restrictions apply to trades in Canada within a certain period of time after the company becomes a "reporting issuer". In simple terms, the company will not become a reporting issuer (and the clock will not start ticking on Canadian resale restrictions) until the company files a prospectus and receives a receipt therefor from the applicable Canadian securities commission(s). In the context of a Canadian company doing a Canada-only IPO, shareholders will generally be subject to resale restrictions until one year has elapsed from the date of the IPO. This does not coincide with the expectations of most U.S. investors, who would normally only be subject to a contractual lock-up agreement running for an average of four to six months after the IPO. (Interestingly, under

the new resale rules recently adopted in Ontario, a shorter four month hold period is available to the employees of certain listed companies, such that employees may, in the absence of contractual restrictions, see an exit prior to the investors.) One increasingly common approach to ensure that investors in a Canadian issuer are liquid within a reasonable time is to require the issuer to qualify the conversion of preferred shares in an IPO prospectus filed in Canada. This approach is similar to the Canadian financing vehicle known as a "special warrant" offering which achieves the same result. U.S. investors may want to negotiate such a qualification requirement, in addition to the usual U.S. registration rights, in order to eliminate the one year statutory resale restriction and limit any hold period to the negotiated lock-up.

The second distinct aspect of the Canadian securities regulatory regime is the statutory escrow requirement triggered at the time of a Canadian or cross-border Canada/U.S. IPO. In Ontario, an escrow regime will be imposed under OSC Policy 5.9, or, at the election of the issuer, under the recently-introduced proposed National Policy 46-201. While NP 46-201 is more permissive than the "old" policy, it can still result in escrow for certain holders for up to three years. Note, however, that like OSC Policy 5.9, NP 46-201 exempts certain issuers from escrow requirements entirely - for example, shareholders of issuers with a market capitalization of more than Cdn.\$100 million post-IPO will generally not be subject to escrow. If there is an escrow requirement under NP 46-201, directors, senior officers, "promoters", and persons holding more than twenty percent of the voting rights attached to the issuer's securities before and immediately after the IPO will be subject to escrow. Persons holding between ten and twenty percent of the voting rights attached to the issuer's securities before and immediately after the IPO may also be subject to escrow if the holder also has a right to elect a director or senior officer of the issuer. NP 46-201 does allow for certain secondary offerings in Canada or in the U.S. (such as firmly underwritten offerings) by holders who would otherwise be subject to escrow. If a U.S. investor is concerned that its level of shareholding will subject it to Canadian statutory escrow requirements, the investor may wish to negotiate a veto right or other limitations on the company's ability to undertake an initial public offering in Canada.

RECENT CHANGES TO THE CANADA BUSINESS CORPORATIONS ACT

"Focus on CBCA Amendments" (accessible on our web site), summarizes changes to the CBCA and regulations which became effective November 24, 2001.

The most significant change of relevance to non-Canadian investors is repeal of the requirement that a majority of the board of directors of a CBCA company must be resident Canadians, and the prohibition on transaction of business at a board meeting unless a majority of the board of directors present are resident Canadians. This has been replaced by a requirement that, subject to exceptions for companies engaged in certain culturally sensitive industries, only twenty-five percent of the directors need to be resident Canadians, or if there are less than 4 directors, at least one must be a resident Canadian. Committees of boards are no longer required to have any resident Canadian directors. In terms of quorum, the CBCA now allows the transaction of business at a directors meeting where at least twenty-five percent of the directors present are resident Canadians. The revisions have also eliminated duplication and overlap with provincial securities laws and have clarified duties and liabilities of directors and officers. To take advantage of these changes, we are recommending that CBCA companies (including subsidiaries of U.S. companies) amend or replace existing by-laws.

By way of background, in Canada, corporations can be formed under the CBCA or one of the provincial corporations statutes. Some of the provincial statutes - such as the *Business Corporations Act* (Ontario) - still have "majority Canadian" residency rules for directors, while others - such as the corporations statutes for Nova Scotia and New Brunswick - have no residency requirements. As a result of the recent modernization of the CBCA, our initial preference is now for a CBCA company if a Canadian corporation is desired.

EQUITY INCENTIVE PLANS FOR CANADIAN EXECUTIVES, EMPLOYEES AND CONSULTANTS - COMPLIANCE WITH ONTARIO SECURITIES LAWS

U.S. companies are accustomed to working closely with legal counsel to ensure that stock option plans and other equity incentive plans comply with U.S. federal and state tax and securities laws. Companies with a presence on both sides of the border must also ensure that equity incentive plans comply with Canadian securities laws, which in many respects are quite different from corresponding U.S. rules.

Prior to 1998, a fairly broad prospectus and registration exemption was available for companies wishing to issue securities to Ontario employees. This changed in 1998, when the Ontario Securities Commission introduced Rule 45-503, which currently governs prospectus and registration exemptions for issuances to Ontario employees, executives and consultants. OSC Rule 45-503 covers

requirements for stock option plans and employee stock purchase plans.

While OSC Rule 45-503 imposes minimal requirements on grants of securities to employees, the rule is more onerous when it comes to awards to executives (directors and officers) of companies which do not have shares listed on a stock exchange in Canada. Two possible exemptions are available to U.S. and Canadian companies which issue securities as compensation to Ontario-resident executives:

1. OSC Rule 45-503 provides a prospectus exemption for companies which are not "reporting issuers" in Ontario, if the company either has shares listed on certain exchanges outside of Canada (including the Nasdaq Stock Market) or has a "de minimus Ontario market". An issuer will not have a "de minimus Ontario market" if Ontario residents are the registered or beneficial owners of more than ten percent of the outstanding securities of the class of securities proposed to be issued, or represent more than ten percent of the total number of security holders of that class. If a U.S.-based company does not qualify for this limited prospectus exemption, and it wishes to issue equity incentives to Ontario executives, it must qualify for the second exemption described below.

2. Unless a company can rely on the special prospectus exemption applicable to foreign issuers described above, OSC Rule 45-503 imposes restrictions on unlisted companies which issue securities to directors and officers under equity incentive plans. The principal restrictions involve limits on the number of securities that can be granted to executives as compensation. For example, the number of stock options granted to executives as a group (which includes both U.S. and Canadian executives) under all of the equity incentive plans of the issuer cannot exceed ten percent of the total number of the outstanding shares of the applicable class. There are similar limits on option grants and stock awards to individual executives. For instance, the number of stock options granted to any one executive and that executive's associates under all of the equity incentive plans of the issuer cannot exceed 5% of the total number of outstanding shares of the applicable class. These limitations can give rise to difficulties. For example, if a company needs to re-constitute its management team as a result of the departure of one or more founders, the permitted pool of options available for grant to executives can be quickly exhausted. It is possible to exceed these limits, provided that prior shareholder approval is obtained from "disinterested" shareholders. In order to obtain this approval, it will generally be necessary to hold a shareholders meeting and provide shareholders with detailed disclosure regarding the

company's equity incentive plans. If shareholder approval is not obtained, limitations will apply. As a technical matter, if appropriate shareholder approval is not obtained, the limitations should be included in the text of the equity incentive plan, which may require a plan amendment if the issuer's original plan was drafted without the benefit of Canadian legal advice.

A further aspect of OSC Rule 45-503 which U.S. issuers with operations in Canada should be aware of is that only Ontario consultants who meet certain requirements are permitted to receive equity incentives on a prospectus exempt basis. An Ontario consultant must be engaged on a bona fide basis to provide consulting, technical, management or other services to the issuer, under a written contract, and must spend (or plan to spend) a "significant amount" of time and attention on the affairs and business of the company. In light of this definition, care must be taken in granting incentives to members of technical or advisory boards, who generally spend a limited amount of time on the company's affairs.

Except in limited cases of securities issued by companies with a "de minimus Ontario market" at the time of the initial trade and whose shares are listed on a foreign market, securities issued to Ontario residents under an equity incentive plan will be subject to Ontario resale restrictions even if the only public market is in the United States. Briefly, unless a resale exemption is available, holders will not be permitted to resell options or underlying shares unless 12 months have elapsed from the later of the date of acquisition of the securities and the date that the company becomes a "reporting issuer" in Ontario. In certain cases, the 12 month period may be shortened to 4 months, although for the time being an application for discretionary relief must be made to the OSC to receive the shortened 4 month hold period. Many U.S.-based companies are not and have no plans to become a "reporting issuer" in Ontario (which essentially involves filing a prospectus in Ontario) or any other jurisdiction of Canada. This means that, in the case of a company which goes public on Nasdaq or another U.S. exchange, Ontario employees may be subject to an indefinite hold period unless steps are taken to give them liquidity (such as obtaining exemption orders from applicable Canadian securities commissions).

As a final note, companies which issue securities to Ontario residents pursuant to OSC Rule 45-503 have filing and fee payment obligations.

This update deals with Ontario securities laws only. It is important to note that to the extent a company wishes to issue equity incentives to residents of a province other than Ontario, the securities laws of that province must also be considered.

DEBT FINANCING TRANSACTIONS - CRIMINAL RATE OF INTEREST ISSUES

In debt finance transactions, U.S. lenders and counsel should be aware that Canadian criminal laws designed to protect vulnerable parties from "loan sharking" can also capture tightly negotiated transactions between sophisticated parties. The *Criminal Code* makes it an offence to charge a "usurious" rate of interest - that is, an effective annual interest rate that exceeds sixty percent of the principal advanced. Criminal laws define "interest" broadly to capture not only the stated rate of interest, but also other arrangements which may result in an ancillary benefit for the lender. Unlike the similar laws of certain U.S. states, application of the *Criminal Code* provisions cannot be waived by the borrower. This can be an issue in common debt financing transactions that involve an equity aspect. For example, many technology companies in capital-intensive sectors negotiate equipment lease financing deals which include an equity "sweetener", and convertible debt bridge arrangements by existing investors often include warrant coverage. Even though the stated interest rate may be within an acceptable range, the equity components of these transactions may result in an imputed interest rate sufficient to give rise to an offence under the *Criminal Code*. For instance, in a convertible debt deal, courts may take into account any increase in the value of the shares received on conversion from the date the debt was advanced. As a further example, in the case of warrants granted to a lender with a strike price below the fair market value of the underlying shares, the difference between the fair market value and the strike price may also be deemed to be "interest". Unfortunately, the law is unclear in Canada, and although we do not believe that the usury provisions of the *Criminal Code* were intended to capture these types of transactions, we cannot be sure, and, therefore, lenders and counsel delivering enforceability opinions must be aware of the risks.

As a bottom line, where a Canadian lender or borrower is involved in a debt financing transaction, U.S. lenders and their counsel should consider whether the lender will in fact receive a criminal rate of interest, taking into account not only the stated rate of interest, but also applicable fees, expenses, penalties, commissions, equity conversion options and warrant coverage.



EMPLOYMENT LAW ISSUES

Although this is not a new topic, U.S. investors and their advisors are often surprised by the “employee friendly” nature of the employment laws in Ontario and other Canadian provinces. These concerns arise both at the time of making investments in Canadian companies and at the time of acquiring Canadian companies. U.S. companies with interests in Canada often have “employment at will” employment contracts which are not recognized in Canada because no employment in Canada may be terminated without providing appropriate notice and severance in accordance with employment standards legislation, and possibly additional common law notice as well. It is possible to limit this exposure, however, by drafting appropriate letters of hire or employment contracts which comply with applicable Canadian laws. In particular, Ontario employers can contract out of the common law entitlements which can substantially increase entitlements from the minimums provided under the *Employment Standards Act*. However, the wording has to be carefully drafted as it is constantly subject to challenge in Ontario courts. In addition, exposure under stock option plans can also be limited by ensuring that plans provide that options will cease to be exercisable upon an employee being given actual notice of termination (as opposed to the expiry of the applicable statutory and/or common law notice period).

A final reminder is that the copyright laws in Canada differ from the U.S., and it is therefore important that intellectual property agreements signed by employees also include a waiver of “moral rights” in addition to provisions which would be substantially similar to those we see in U.S. documents. As with many of the corporate issues discussed above, we can readily “Canadianize” many of these documents based on our past experience, but it is important that we be given an opportunity to do so before it is too late.

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