On Target

2024 Private Equity Outlook

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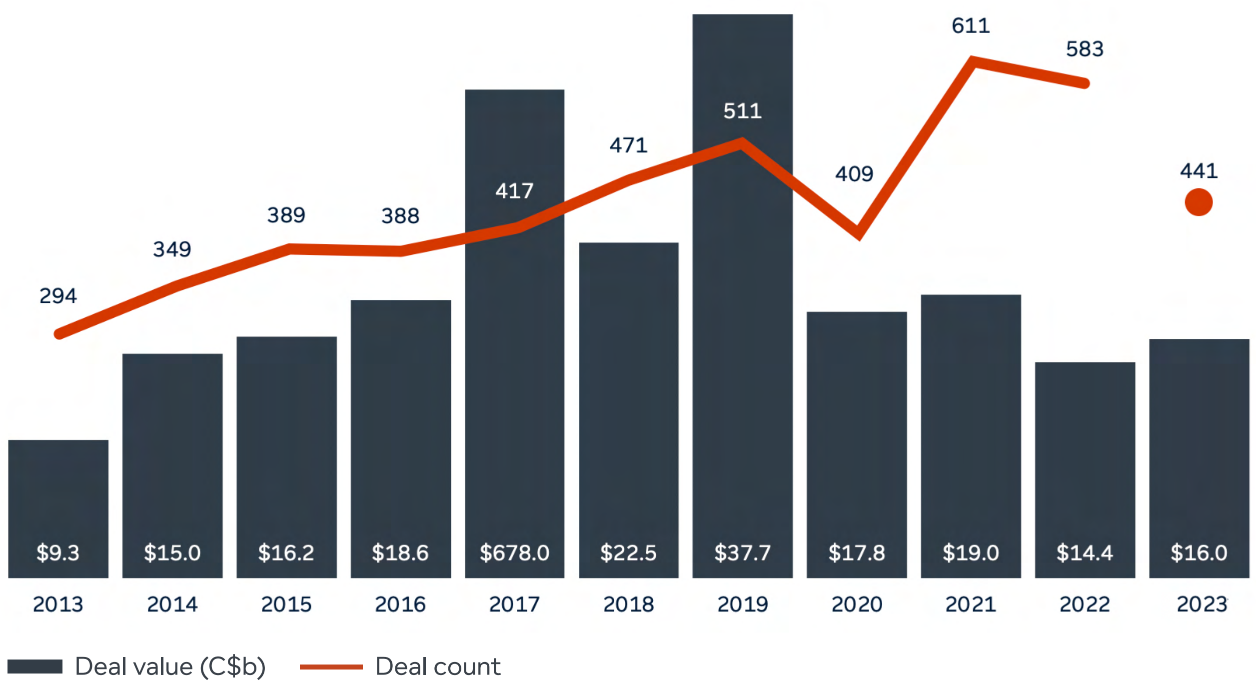
2023 in Numbers —
Canadian Private Equity Overview

Despite the impact of inflation, a steady increase in interest rates, volatility in the market, concerns about a possible recession and global geopolitical uncertainty, the Canadian private equity market remained quite active in 2023. As of December 5, 2023, 441 private equity transactions have closed in 2023 for a total deal value of C$16 billion. In 2017, 2018 and 2019, there was a year-over-year increase in both deal count and deal value, followed by a decline in such metrics in 2020. The numbers as of December 5, 2023 track with 2020 with respect to both deal value and deal count. From 2020, deal count increased significantly in 2021 and 2022 (608 deals in 2021 and 581 deals in 2022), although deal value remained largely flat during that period.

The total 2023 deal value of C$16 billion as of December 5, 2023 remains relatively robust compared to the C$14.4 billion of total deal value for 2022 (see the Canadian Deal Size section below for more information).

Canadian PE Deal Flow by Year

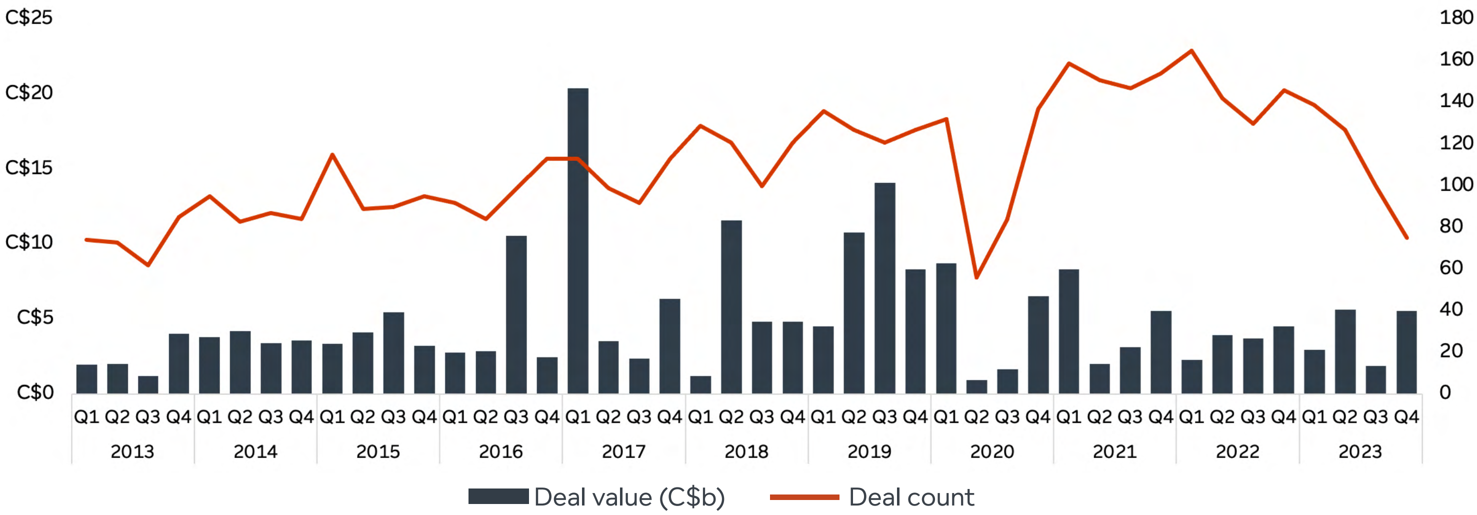


This chart compares both deal value and deal count between 2013 and December 5, 2023.[1]

Despite the overall strength in these 2023 numbers, deal count steadily declined in each of the first three quarters of 2023: 139 transactions closed in the first quarter, 127 transactions closed in the second quarter and 100 transactions closed in the third quarter. The second quarter was the strongest in terms of deal value, totalling C$5.6 billion of disclosed deal value.

1 Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis.

Canadian PE Deal Flow by Quarter



This chart compares both deal value and deal count by quarter in 2023.[2]

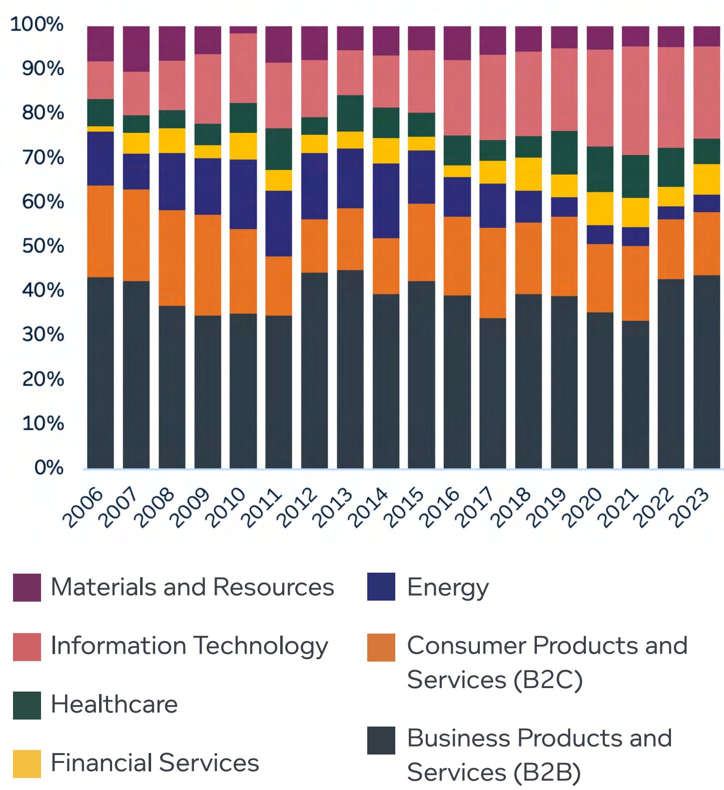
Canadian private equity deals involving a U.S. investor have continued to be an important part of the market, possibly in part due to a relatively weaker Canadian dollar. These transactions now represent more than 50% of all Canadian private equity deals.

CANADIAN PE BY SECTOR

Although energy transition was one of the hot topics of the year, in terms of deal value by sector, energy deals (C$1.85 billion) lagged behind information technology deals (C$8.08 billion) and financial services deals (C$2.44 billion).

In terms of deal count by sector, B2B led the way, with 193 transactions (a position that it has held during the 17 years for which information is available). Information technology is in second place, with 92 transactions, and B2C transactions moved into third place, with 63 transactions, surpassing financial services, which ranked fourth, with 31 transactions, followed by energy, with 17 transactions.

Canadian PE Deal Count by Sector



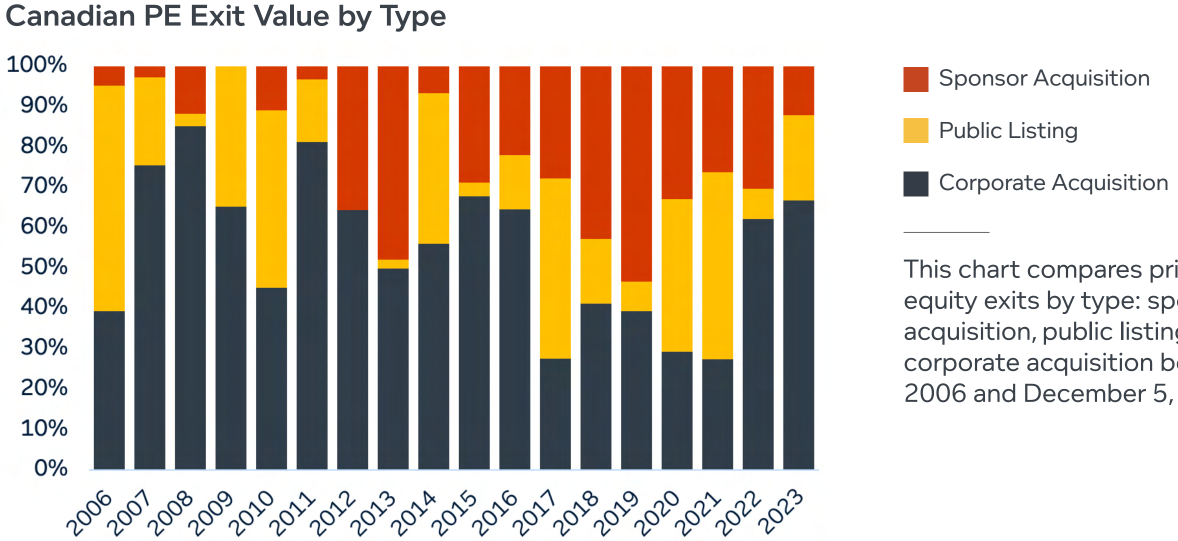
This chart highlights deal count by sector between 2006 and December 5, 2023.[3]

2 Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis.
3 Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis.

CANADIAN PE-BACKED EXITS

The downward trend in private-equity-backed exits in Canada that started last year (146 transactions for C$14.15 billion) took a sharp further downward turn between January 1 and December 5, 2023 in terms of both exit count and exit value (88 transactions for C$3.72 billion). Numbers this low have not been seen in more than a decade.

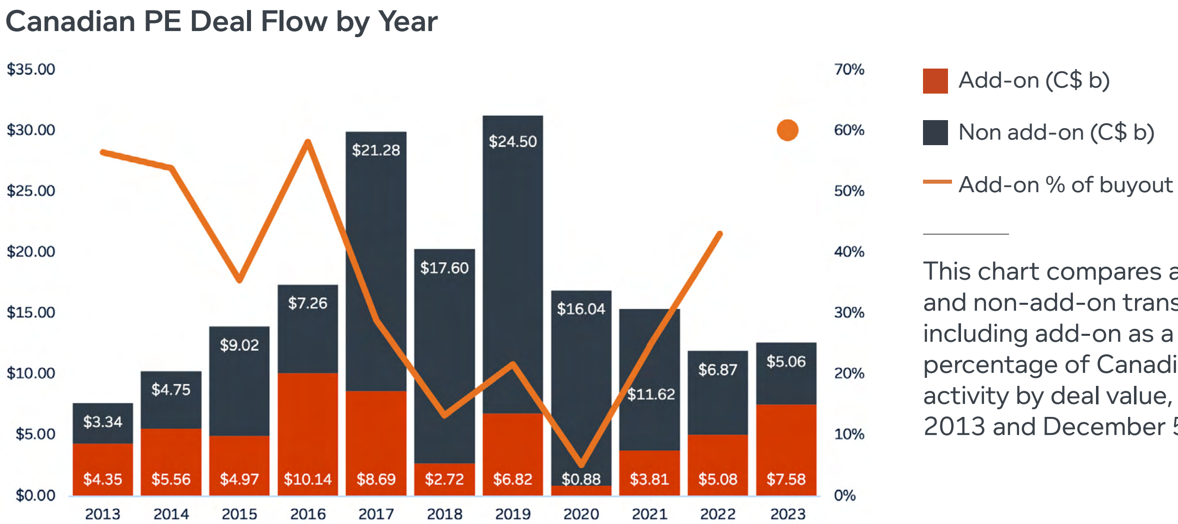
M&A exits and secondary buyouts have remained the preferred type of exit because the Canadian IPO market remains largely unavailable.



This chart compares private equity exits by type: sponsor acquisition, public listing and corporate acquisition between 2006 and December 5, 2023.[4]

CANADIAN ADD-ONS

Add-on acquisitions continue to account for the bulk of private equity buyouts in Canada, representing 70.3% of 2023 deal count as of December 5, 2023 (versus 74.2% in 2022) and 60% of 2023 deal value (up from 42.5% in 2022, and the highest recorded percentage since 2006).



This chart compares add-on and non-add-on transactions, including add-on as a percentage of Canadian buyout activity by deal value, between 2013 and December 5, 2023.[5]

4 Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis.
5 Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis.

CANADIAN DEAL SIZE

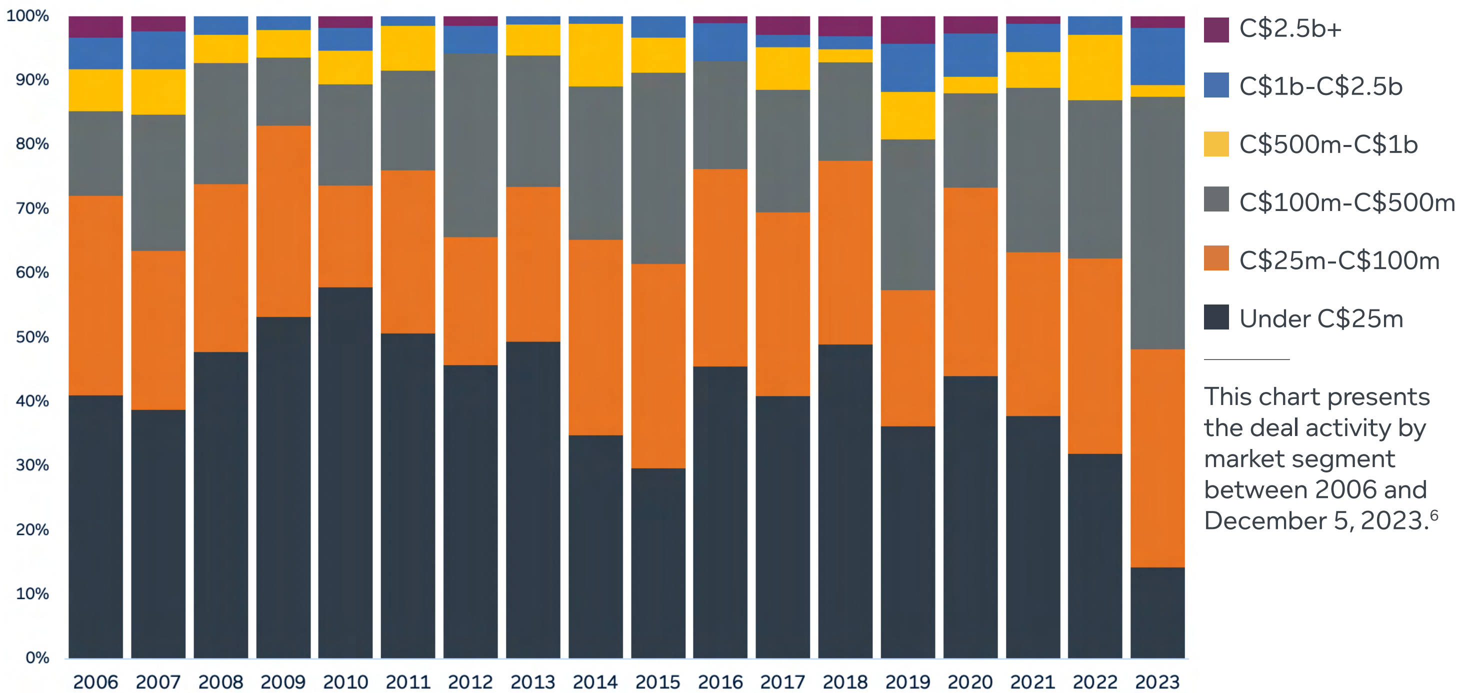
As of December 5, 2023, there have been five completed 2023 transactions in the C$1 billion to C$2.5 billion market segment and one completed 2023 transaction in the above C$2.5 billion market segment, which contributes in large part to the total reported deal value for the first three quarters of 2023 as compared to 2022 (which featured only two transactions in the C$1 billion to C$2.5 billion market segment and no transactions above C$2.5 billion). The number of deals has decreased in all other deal-size segments between 2022 and 2023, other than in the C$100 million to C$500 million segment. Deals in the C$25 million to C$100 million segment and in the C$100 million to C$500 million segment continue to be the backbone of private equity deals in Canada.

There has been a significant decrease in the number of 2023 deals in the under C$25 million market segment, with only eight such transactions completed as of December 5, 2023. This is a stark decline from previous periods, given that between 2006 and 2022, the number of such deals ranged from 22 transactions in 2022 to 48 transactions in 2018.

CANADIAN PE FUNDRAISING

After the dramatic decline in fundraising in 2022, as of December 5, 2023, C$32.18 billion was raised in Canada in 2023 by 10 traditional private equity buyout and similar funds (including Brookfield Capital Partners VI and Whitehorse Liquidity Partners V), compared to C$2.1 billion of capital raised in 2022 by 19 funds. The amount raised in 2023 is the highest of the last 10 years, with the next best year being the C$23.46 billion raised in 2019 for 22 funds.

Canadian PE Deal Count by Size



This chart presents the deal activity by market segment between 2006 and December 5, 2023.[6]

CONCLUSION

Given the current market environment, private equity firms need to find new ways to underwrite risk for the right asset, strategy and value-creation plan. Canada did not dip into a recession in 2023, but economic deceleration may continue into 2024, inflation will likely remain higher than the norm of the past two decades and interest rates should stabilize. We nevertheless expect to continue to see innovative and creative ways of getting deals done. The long-term outlook for private equity remains sound.

6 Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis.

Trends in Global Fundraising

THE MALAISE CONTINUES[7]

After a year of widespread geopolitical turbulence, rising interest rates and banking turmoil in the United States, it is no surprise that global private equity fundraising activity remained slower in 2023 compared to the frenetic pace of 2019 to early 2022. The denominator effect, which resulted in investors being overweight in private assets relative to public market assets, combined with the lack of capital returned to investors due to the slowdown in the M&A and IPO markets, resulted in many investors slowing the pace of their fund commitments in 2023.

As of September 30, 2023, the value of global private capital raised for the trailing 12 months was US$1.16 trillion, a decrease of roughly 14% compared to the figure as of September 30, 2022.

Despite the continued economic headwinds of 2023, some strategies proved more resilient than others. Secondaries fundraising exceeded US$68 billion in just the first three quarters of 2023 (compared to US$57.6 billion raised over all four quarters in 2022), suggesting there is increasing momentum and continued confidence in secondaries opportunities. Private debt fundraising remained on pace with the previous year, with mezzanine lending having a banner year and keeping pace with the stalwart direct-lending strategy, reflecting an ongoing demand for private credit in the wake of financial institution pullback and higher interest rates.

One sector that saw the biggest decline in fundraising in 2023 was real assets, representing a year-over-year decline of almost 86% for the trailing 12 months measured as of September 30 for 2023 and 2022. Similarly, global venture capital fundraising declined significantly during 2023, driven primarily by the absence of large funds (i.e. those greater than US$1 billion), which accounted for almost half the fundraising totals in 2022.

With a muted IPO market and the M&A market continuing to ebb since hitting its peak in 2021, continuation funds remain a popular means for sponsors to offer their investors liquidity and for investors to gain exposure to mature and high performing portfolio companies with shorter holding periods. Capital remains available for continuation fund opportunities as a result of the strong secondaries fundraising noted above.

The year also experienced steady co-investment activity, despite the slow M&A market. With sponsors suffering from a dearth of capital that would otherwise be available for deployment due to fundraising challenges, the difficulties in securing traditional debt financing and the increased cost of that debt financing when available, co-investments continued to be an attractive option for sponsors in 2023.

Despite the relatively soft current fundraising environment, we have yet to see a full retreat from the sponsor-friendly fund terms of the preceding high demand environments of 2019 to early 2022. With investor capital being scarcer than

7 All data in this section is based on information from PitchBook Data, Inc.'s Global Private Market Fundraising Report. The information presented in this section for 2023, is current as of November 6, 2023.

in previous periods, it would be reasonable to expect a surge in investor bargaining power, but such rebalancing between sponsors and investors has yet to fully materialize, as sponsors are reluctant to give up the favourable terms they were able to negotiate in funds raised when the market was strong. Despite this general trend, we have seen sponsors more willing to offer fee discounts to seed and early-close investors to kick start their fundraising processes. A number of other trends we have seen in fund terms are noted below, with several of them being generally sponsor-favourable as a result of the momentum from the former high demand environment. We expect to see less of this momentum in 2024 and the overall trend toward more sponsor-favourable terms to slow or reverse.

With many of the root causes of the fundraising slowdown still relevant, we expect the fundraising environment to remain tepid into 2024, picking up when the M&A market gets into high gear, with M&A exits returning capital that investors can reinvest in new funds.

TRENDS IN FUND TERMS

Continuation fund provisions: As we noted in our 2023 Private Equity Outlook, continuation funds have become increasingly popular in recent years. As a result, fund documentation often now includes clauses setting the parameters of a future continuation fund transaction. These clauses may mandate the option for limited partners to sell or roll their interest in the applicable portfolio company and describe the legal steps to accomplish this and/or timelines, approval thresholds and other mechanics. Sponsors aim to give themselves maximum flexibility when structuring a future continuation fund transaction. Limited partners often try to resist agreeing to the terms or process of a continuation fund transaction in advance — before they are presented with the full facts of the particular situation.

Given the ongoing popularity of co-investments, limited partners have also begun to look ahead to the implications of a continuation fund exit from a co-investment. In particular, co-investors often seek the same option that is given to main fund investors to either sell their interest in the applicable portfolio company or to roll that interest into the continuation fund. Unlike in a main fund, co-investors often participate in co-investments on a no-fee, no-carry basis. If given an option to roll their interest into a continuation fund, co-investors prefer to preserve those economics and so may seek an upfront agreement from the sponsor to that arrangement.

Although a market norm around continuation fund clauses and side letter provisions has yet to fully develop, we expect one will emerge in time given their prevalence.

Extensions to the fundraising period: Although historically the most common fundraising period was 12 months, with many funds needing far less time to reach or exceed their target in the frothy market of 2019 to early 2022, fund documentation has more recently included longer fundraising periods and greater flexibility for unilateral extensions by the sponsor. As a result of the current challenging fundraising environment, many funds have resorted to ad hoc extensions to their fundraising period approved by the limited partner advisory committee or the limited partners themselves, extending the fundraising period to as long as 30 months. Rather than rely on those approvals for future fundraises, sponsors have started to include longer fundraising periods from the outset. One consequence of this is that it extends other periods in the fund documentation to the extent they are triggered off of the final closing date, such as the investment period and the fund term.

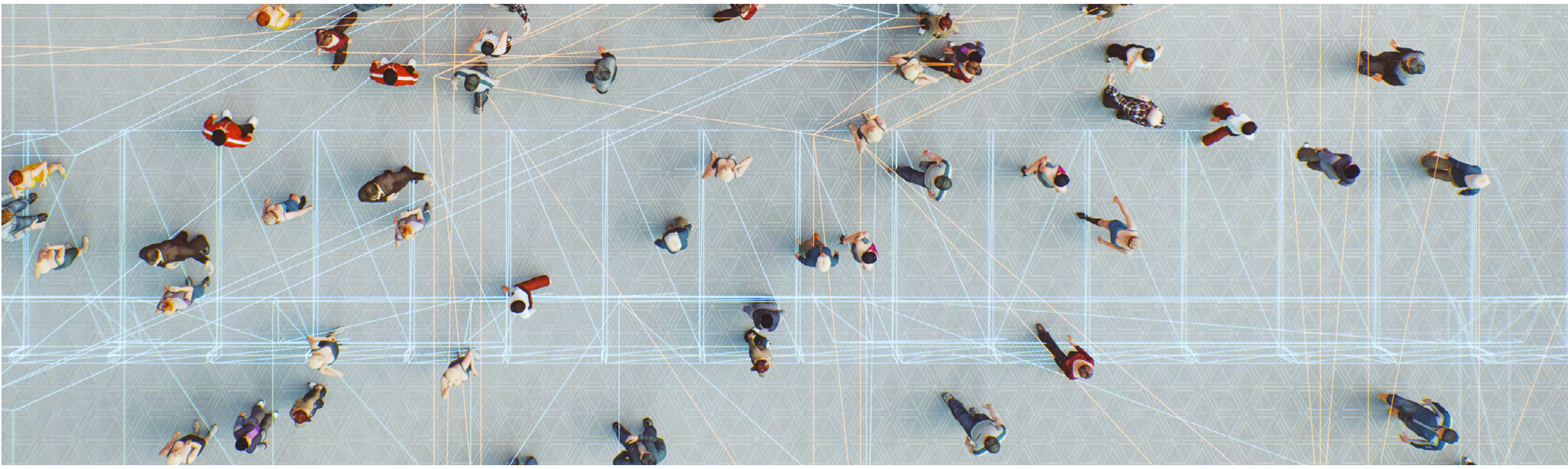
Expanded expense provisions: As a result of the call by limited partners for greater visibility into the expenses charged to the fund as well as in response to increased regulatory scrutiny, sponsors continue to clarify what qualifies as either organizational expenses or partnership expenses borne by the fund. It is not unusual for the definition of "partnership expenses" to now extend several pages, with the definition lengthening with each successive vintage of a fund. Although this transparency may be viewed as limited-partner-friendly, investors review the additions to ensure that nothing properly viewed as sponsor overheard is added to the list of expenses. One item that is appearing on more lists of partnership expenses is environmental, social and governance (ESG) reporting. Although few investors take issue with ESG reporting relating to the fund itself, they will try to exclude ESG reporting related to the sponsor, viewing that as a sponsor expense.

A related trend is the movement of expenses that were previously categorized as organizational expenses (which are typically capped) to partnership expenses (which are typically uncapped). In particular, funds are increasingly categorizing the expenses of administering the "most-favoured nation" process as partnership expenses. This is combined with a continued trend towards higher caps on organizational expenses, with the cap on organizational expenses often increasing from one vintage of a fund to another by a larger percentage than the step-up in fund size, with sponsors citing more regulatory burden and general inflation as primary drivers of the increase.

Non-offsetting services provided to portfolio companies: Sponsors, their principals and their related entities often provide services to the fund's portfolio companies. Transaction fees, directors' fees, monitoring fees and other similar fees received in connection with those services still typically offset the management fee borne by fund investors on a dollar-for-dollar basis. Many large sponsors have specialty value-add units within or affiliated with their organization that provide consulting or advisory services to portfolio companies. These sponsors have increasingly sought to clarify that the fees received by these units do not offset the management fee on the basis that these are separate business units, in most cases unrelated to the sponsor's main advising and management activities, providing arm's length services to portfolio companies that ultimately benefit the limited partners. Likewise, sponsors may provide back-office services —such as in-house legal or accounting services — to portfolio companies, for which they receive payments from the portfolio companies that do not offset the management fee.

Limited partners may argue that these are the type of services that should be included in the management services for which the fund is paying the management fee. Sponsors will counter that they are not obligated to provide these services, which are additional services that the portfolio companies would otherwise typically obtain from third parties rather than the manager so there is no additional cost to the fund as long as the services are charged at cost or on arm's length terms and the sponsor should not be made worse off by providing these services. We are seeing provisions dealing with these types of fees now being added even in funds with smaller sponsors without value-creation units in anticipation of adding this service in the future.

Expanded unilateral amendments: Amendment clauses in fund documentation typically permit sponsors to make unilateral amendments in respect of some matters without limited partner approval, such as to correct clear typographical errors or relating to the admission of additional partners. Sponsors have increasingly sought to expand this list of permitted unilateral amendments, including amendments to account for changes to tax law or policy that would have an effect on the tax treatment of the sponsor's carry, and amendments that may be required to address the recently adopted United States Securities and Exchange Commission private fund adviser rules once implemented. Although sponsors' rationale for these additions is flexibility in the face of uncertainty, limited partners often try to prescribe that no such amendments will have an adverse effect, or a material adverse effect, on the limited partners without their consent. Limited partners also seek to impose 100% of the cost of carry-treatment amendments on the sponsor because those amendments exclusively benefit the sponsor and its principals.



Addressing Conflicts of Interest

The Canadian Securities Administrators and the Canadian Investment Regulatory Organization have recently introduced significant amendments to registrant conduct obligations related to the proper identification and handling of material conflicts of interest. These reforms were implemented in order to better align the interests of registrants with the interests of their clients, improve outcomes for clients and make clearer to clients the nature and the terms of their relationship with registrants, and ultimately resolve such conflicts in the best interest of clients. This regulatory approach is substantively similar in scope to how the common law expects fiduciaries to address conflicts of interest.

Although most private equity firms are not registered under Canadian securities laws and are therefore not subject to the legislative obligations imposed on registrants, they nevertheless will often be recognized by the common law to be fiduciaries. Accordingly, private equity firms should be identifying and addressing conflicts of interest within their business and funds, because the requirement to act in the best interests of the client by addressing conflicts of interest also arises from the fiduciary duty that frequently attaches to private equity firms.

Furthermore, the United States Securities and Exchange Commission (SEC) has also increased scrutiny on conflicts of interests in private equity firms. For example, in 2020, the SEC's Office of Compliance Inspections and Examinations conducted an examination of registered investment advisers that managed private equity funds or hedge funds and found that one of the key areas of deficiencies was conflicts of interest.[8] The importance of making full and fair disclosure of conflicts of interest was also emphasized in its report. In order to identify and address conflicts of interest, the SEC has strongly suggested that private equity firms should use limited partner advisory committees for their funds.

Examples of conflicts of interest private equity firms may be subject to and should consider addressing or avoiding include:[9]

— allocation of investment opportunities or fees and expenses between clients. For example, the SEC's 2020 report found that some private fund advisers preferentially allocated limited investment opportunities to new or higher fee-paying clients, thereby depriving certain investors of limited investment opportunities without adequate disclosure.[10]

— multiple clients invested in different layers of a particular investment. For example one client owning debt and another client owning equity in a single portfolio company.[11]

— the provision of advisory or affiliated services by a private equity firm or its related persons to the fund or a portfolio company. For example, the SEC recently announced a US$1.6 million settlement with a California-based registered investment adviser of private funds resulting from the firm breaching its fiduciary duty in numerous areas, including by not adequately disclosing its conflict of interest when it lent money from one private fund it managed to a new private fund managed by an affiliated adviser, and by failing to determine if the loan was in its clients' best interest.[12]

8 See https://www.sec.gov/files/Private%20Fund%20Risk%20Alert.pdf (SEC Report).
9 See Footnote 14 of https://www.sec.gov/news/statement/crenshaw-statement-private-fund-advisers-082323#_ftn14.
10 See SEC Report, page 2.
11 See SEC Report, page 2.
12 See https://www.sec.gov/news/press-release/2023-193.

— entering into agreements with select investors through "side letters" that establish special terms, including preferential liquidity terms. Not providing adequate disclosure about these side letters can result in some investors being unaware of the potential harm that could be caused if the selected investors with side letters exercised the special terms granted by the side letter.[13]

— advisers in private equity firms having interests in investments recommended to clients, such as undisclosed pre-existing ownership interests or other financial interests, such as referral fees or stock options in the investments.[14]

The SEC very recently introduced new rules[15] applicable to private fund advisers to help address some of the above potential conflicts of interest, including: increased transparency to investors regarding fees and expenses, and relationships with private fund advisers. The new rules also forbid private fund advisers from giving "preferential treatment" to certain investors (a common practice through so-called side letters between private fund advisers and institutional investors) unless they offer the same terms to the other investors in a fund.

Overall, the increased regulatory scrutiny in both the U.S. and Canada with regards to conflicts of interest is something private equity firms should consider strongly when enhancing their internal policies and procedures, and, at the very least, implement a limited partner advisory committee to help identify and address conflicts of interest.

Foreign Direct Investment: The Looming Threat of National Security Reviews

Foreign investment review has become an increasingly important tool for the government of Canada to assess potential risks to Canada's national security. The *Investment Canada Act* (ICA), Canada's foreign direct investment law, authorizes the federal government to review any foreign investment in an entity operating in Canada to determine if it could be injurious to Canada's national security. National security reviews are suspensory, meaning that parties cannot close their transaction until the responsible Minister has determined that the transaction is not injurious to national security, or sufficient mitigation measures are established to alleviate the government's national security concerns.

In the 2022-2023 fiscal year, 22 national security reviews were ordered among the almost 1,000 investments notified under the ICA, of which 10 were permitted to proceed (either with no further action or with sufficient mitigation to alleviate national security concerns), eight were withdrawn by the foreign investor and three were subject to a divestiture order from the Federal Cabinet. Although this seems nominal, it is almost double the number of national security reviews ordered in the previous fiscal year and comes in a year where the total number of investments notified under the ICA declined by about 20%. The federal government's heightened foreign investment scrutiny suggests that the number of national security reviews will continue to rise in 2024 and beyond. Although investors from so-called "non-like-minded" jurisdictions, such as China, have thus far been the primary target of the national security regime, investments from any foreign entity, including U.S. and other non-Canadian private equity firms — in sensitive industries such as dual-use technologies, health and bio technology, military and defence, space and critical infrastructure — are also likely to be closely examined under the national security regime going forward.

The federal government has recently taken a number of steps toward revamping the ICA's national security regime with the aim of mandating or incentivizing the disclosure of transactions with potential national security implications. All acquisitions of control by a non-Canadian of a Canadian business are subject to review or notification under the ICA. Investments that do not exceed certain prescribed monetary thresholds — and are therefore not subject to a "net benefit to Canada" economic review — are nevertheless subject to mandatory notification, which must be filed before closing or within 30 days after closing. Other transactions, such as minority investments, do not need to be notified but the federal government can initiate a national security review with respect to an unnotified investment at any time within five years after closing. By making a voluntary notification, foreign investors can reduce the time frame within which the government may initiate a national security review from five years to 45 days, providing regulatory certainty once this much-shorter time period has expired. Given the ever-evolving nature of national security concerns and geopolitical

13 See SEC Report, page 3.
14 See SEC Report, page 3.
15 See https://www.sec.gov/rules/2022/05/private-fund-advisers-documentation-registered-investment-adviser-compliance-reviews.

alliances, private equity firms making minority investments in potentially sensitive industries should consider the benefits of leveraging the voluntary notification to head off regulatory concerns that may arise years down the road.

In a similar vein, Bill C-34, *An Act to Amend the Investment Canada Act*, proposes to subject certain foreign investments — whether minority or control acquisitions — to a mandatory pre-implementation notification to enable the government to initiate a national security review prior to closing. This new regime would apply to foreign investments in an entity operating in Canada by any non-Canadian investor (whether private or state-owned) where:

— the Canadian business carries on a "prescribed business activity." These activities will be defined in future regulations but are anticipated to include high-risk industries identified in the federal government's *Guidelines on National Security Review of Investments*, such as dual-use technology, critical goods, critical infrastructure, businesses that use or handle sensitive personal data and any products subject to defence-related export controls;

— the foreign investor would gain access to, or the ability to direct the use of, "material, non-public technical information" or "material assets." These terms will also be defined in future regulations but are likely to cover items such as intellectual property, personal data or other sensitive data or know-how; and

— the foreign investor would have the power to appoint or nominate any person with the capacity to direct the business and affairs of the Canadian business (e.g., directors, senior management, trustees or a general partner) or other prescribed special rights with respect to the Canadian business. This requirement is designed to exclude purely passive minority investments from the mandatory pre-notification requirement.

The Standing Committee on Industry and Technology issued its committee report on Bill C-34 in September 2023, clearing the bill to complete its final reading in the House of Commons and continue on to the Senate. Although the current trajectory suggests that Bill C-34 could become law as soon as the first half of 2024, regulations identifying the prescribed business activities subject to the notification requirement and defining other key terminology are unlikely to be developed prior to that time, meaning that the mandatory pre-implementation notification may not come into effect until later in 2024 or even 2025. Nonetheless, U.S.-based and other non-Canadian private equity firms contemplating investments in potentially sensitive industries should keep an eye on the timing of these amendments to ensure that they do not interfere with the timely closing of those transactions.

Opportunities to Generate Long-Term Value in Distressed Assets

Over the course of the last year, the number of restructuring proceedings under the *Companies' Creditors Arrangement Act* (Canada) (CCAA) or the *Bankruptcy and Insolvency Act* (Canada) (BIA) has significantly increased in Canada. Many of these proceedings involve a court-ordered and court-supervised process led by a licensed insolvency trustee or an investment banker to sell the assets of the distressed companies as a going concern, known in the insolvency industry as a sale and investment solicitation process (SISP). Sales realized in the context of a SISP have often been disappointing for creditors holding security over the marketed assets, such that secured creditors may now be reluctant to initiate formal insolvency proceedings. More often than not, secured creditors often anticipate a significant loss when restructuring proceedings require a SISP to be carried out, which on the flip side could create interesting opportunities for private equity firms to pursue their investment objectives at a discount.

A STRIKING INCREASE IN INSOLVENCY PROCEEDINGS IN CANADA

In 2020, the onset of the COVID-19 pandemic and the implementation of lockdown measures led to an increase of approximately 58% in restructuring proceedings instituted under the CCAA as compared to 2019. The sectors with the highest number of insolvency restructurings during this period were retail, manufacturing, mining and oil and gas extraction. Most likely due to substantial government assistance, the rise in restructuring proceedings stopped abruptly in 2021 and 2022, before increasing again in 2023. In 2023, the number of restructuring proceedings under the CCAA was significantly higher than the total for each of 2018, 2019, 2021 and 2022, and, as of November 30, 2023, it was expected that the 2023 total will eclipse the 2020 total. Reduced government assistance and the increase in interest rates, inflation and geopolitical conflicts have put pressure on many businesses. Many have been experiencing difficulties in refinancing their operations with traditional lenders and have little to no choice but to formally restructure under the BIA or the CCAA.

FINANCIAL INSTITUTIONS' DISTRUST OF FORMAL SISP

The sales processes instituted under the BIA or the CCAA over the last year have produced mixed results. One case study is the CCAA restructuring of IMV[16] — a clinical-stage biopharmaceutical company operating mainly in Halifax — which had a market capitalization of over C$300 million in 2020. In 2023, IMV's monitor initiated a SISP by contacting 575 potential bidders, none of which showed interest in the continuation of IMV's operations. The bids received focused solely on IMV's intellectual property, including its patented drug delivery technology. Even combined, the bids received were unsatisfactory to IMV's secured creditor, which filed a credit bid[17] that was retained as the successful bid. The credit bid did not provide for the continuation of IMV, and its operations were ultimately wound down.

16 *IMV Inc. (Re)*, Supreme Court of Nova Scotia File No. 523334 (September 6, 2023).

17 A credit bid is an offer to purchase the assets submitted by a secured creditor pursuant to which it offers as consideration its secured claim, effectively offering to foreclose on the assets.

In another case, PaySlate Inc.,[18] a technology company based out of British Columbia that provides payment processing services, conducted a SISP in the context of the filing of its notice of intention to file a proposal under the BIA in order to identify a purchaser or an investor. The company, with the assistance of the trustee, conducted a SISP pursuant to which 88 potential bidders were contacted and 23 of them signed confidentiality agreements to access a data room.

Notwithstanding these marketing efforts, only one bid was submitted in the form of a credit bid by secured creditors.

Similarly, as part of the restructuring of Endoceutics,[19] a Québec private pharmaceutical company operating in the field of women's health and the prevention and treatment of hormone-sensitive cancer, sale transactions were approved by the Court further to the conduct of a SISP but without the consent of its sole secured creditor, which was in turn seeking the approval of its credit bid. The proceeds generated from the transactions in the context of the SISP were less than 25% of the amount of the secured debt.

The results of the sale processes mentioned in the above cases are not uncommon and several other restructuring cases have ended in similar ways. Secured creditors, aware of the costs associated with conducting a robust SISP and the likelihood of incurring significant losses, have accepted major compromises in restructuring proceedings. For instance, in Groupe Sélection,[20] the SISP approved by the Court provided that the business partners affected by the SISP would always have a final say in the disposal of the marketed assets through, among other things, a mandatory auction process or, if the partners were not participating in the SISP, through a right to choose the successful bid in consultation with the Monitor.

Business rescue presents an interesting opportunity for private equity firms to invest in companies that, with the right resources and support, remain capable of a profitable rehabilitation. By taking advantage of the current opportunities in restructuring proceedings, private equity firms may secure their position in industries with significant barriers to entry. Private equity firms' ability to act quickly and decisively gives them an opportunity to position themselves successfully in sale processes of undervalued assets and potentially generate significant long-term value.

Private Equity Fighting Climate Change

The world is facing a massive challenge fighting climate change and, in 2024 and beyond, private equity should continue to be a driving force behind transition to cleaner energy sources, both in Canada and abroad.

According to the International Renewable Energy Agency, energy transition technologies will need investments of approximately US$131 trillion by 2050 in order to achieve emissions reduction targets.[21] With new regulations forcing ESG standards and practices on businesses of all types and a growing consensus that clear and rapid actions are needed in order to achieve energy transition, investors wish to play a role in this and are demanding the same from private equity funds in which they invest. Energy transition should remain a great topic for investors looking to contribute to the transition to a low-carbon economy while making interesting returns.

Private equity firms, armed with substantial capital and a wealth of experience in deal structuring, risk management and operational efficiency, see many investment opportunities in a broad range of areas that contribute to energy transition. These include renewable energy, electrification of transports, grid flexibility and resilience, next generation fuels, carbon capture and other carbon mitigation technologies. We are also seeing opportunities created by players which act as aggregators and co-ordinators of energy transition, by bundling available financing of all sorts, both governmental and private, and bridging capital gaps with a mix of debt and equity.

18 *PaySlate Inc. (Re)*, 2023 BCSC 608.
19 *Arrangement relatif à Endoceutics Inc.*, 2023 QCCS 1687.
20 *Re Groupe Selection Inc.*, Québec Superior Court Commercial Division File No. 500-11-061657-223 (March 24, 2023).
21 World Energy Transitions Outlook – 1.5º C Pathway, International Renewable Energy Agency, 2021, p.28.

Not so long ago, certain emerging technologies that lacked a proven track record and a robust market failed to attract the capital needed to make it to the next level. But the urgency for energy transition is now changing behaviours and market forces, and in some cases making certain business models sustainable. In addition, subsidy programs — such as the Inflation Reduction Act in the United States and the income tax credits first announced by the Canadian federal government in its 2022 Fall Economic Statement — create significant incentives for developers of clean energy projects and technologies, which synthetically impact business cases. These elements contribute to making economically viable projects and technologies which have not yet reached a maturity stage and further increase the attractiveness of others.

Private equity's role in the energy transition extends beyond capital infusion. It also bolsters innovation within the sector. By providing financing to creative startups and technology firms, private equity firms act as catalysts for even further innovative solutions. Capital enables these companies to scale rapidly, bringing their technologies to market faster.

As Canada and the world continue to address climate change and advance its energy transition, the influence of private equity is set to play an even more prominent role. Collaborative efforts between private equity, government initiatives and industry stakeholders will be key to realizing a greener, more resilient energy future.

Amendments to the Reportable Transaction Rules Under the *Income Tax Act*

On June 22, 2023, new mandatory disclosure rules in the *Income Tax Act* (Canada) (ITA) took effect. These rules expand the range of transactions that taxpayers, as well as advisors and promoters, must report to the Canada Revenue Agency (CRA).[22] Failure to report can result in significant penalties and extended reassessment periods.

The new mandatory disclosure rules are relevant to private equity funds, including at the limited partnership agreement (LPA) drafting and portfolio investment acquisition and divestiture stages. This section discusses the "reportable transaction rules," which form part of the new mandatory disclosure rules.

22 The new mandatory disclosure rules include three general regimes: reportable transactions, notifiable transactions and uncertain tax treatments (UTT).
The new notifiable transaction regime, contained in s. 237.4 of the ITA, generally requires taxpayers (as well as "advisors" and "promoters," as defined) to disclose "notifiable transactions" to the Minister of National Revenue. A "notifiable transaction" is defined as a transaction (or transaction in a series) that is the same or substantially similar to a transaction (or series) that is designated as a notifiable transaction by the Minister of Finance. To date, and effective November 1, 2023, the Minister of Finance has designated five types of transactions to be notifiable transactions: **https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/mandatory-disclosure-rules-overview/notifiable-transactions-designated-by-minister-national-revenue.html**.
Pursuant to the new UTT regime, under s. 237.5 of the ITA, a "reporting corporation" (as defined) is required to report a "reportable UTT." A "reportable UTT" is a tax treatment used, or planned to be used, in the corporation's income tax filings in respect of which uncertainty is reflected in the audited financial statements of the corporation (or a group of which it is a member) for the year.

"Reportable transactions" are transactions that meet certain conditions and therefore must be reported to the CRA. A transaction entered into on or after June 22, 2023 (including a transaction that is part of a series that begins before and ends on or after June 22, 2023) will be a "reportable transaction" if two conditions are satisfied:[23]

— the transaction (or any transaction in the series of transactions) is an "avoidance transaction;"[24] and

— the avoidance transaction (or series of transactions) has at least one of three "hallmarks" — contingent fee, confidential protection or contractual protection.[25]

A transaction is an avoidance transaction if it may reasonably be considered that one of the main purposes of entering into the transaction (or a series of transactions of which the transaction is a part) is to obtain a "tax benefit."[26]

The contingent fee hallmark is generally met where an "advisor"[27] or "promoter"[28] (or person that does not deal at arm's length with an advisor or promoter) is entitled to a fee that is:

— based on the amount of a tax benefit;

— contingent on achieving a tax benefit; or

— attributable to the number of persons who participate in the same or similar transaction or series or have been provided access to advice or an opinion given by an advisor or promoter regarding the tax consequences from the same or similar transaction or series.

The confidential protection hallmark is generally met where: (i) an advisor or promoter (or person that does not deal at arm's length with an advisor or promoter) obtains "confidential protection;"[29] and (ii) a prohibition on disclosure provided under the confidential protection provides confidentiality in respect of a "tax treatment"[30] in relation to the transaction or series of transactions.

The contractual protection hallmark is generally met where the taxpayer (or a person who has entered into the avoidance transaction for the benefit of the taxpayer), an advisor, a promoter or a person that does not deal at arm's length with any of the foregoing, receives "contractual protection"[31] in respect of the avoidance transaction or series. Contractual protection may include insurance, compensation, an indemnity or a guarantee. However, in order to be considered contractual protection, the protection must generally protect a person against a failure of the transaction or series to achieve any tax benefit or be in respect of a dispute related to a tax benefit. Contractual protection generally does not include standard professional liability insurance or protection that is integral

23 Defined in s. 237.3(1). All section references herein are references to the ITA unless otherwise indicated.
24 As defined in s. 237.3(1).
25 Historically, a transaction was only a reportable transaction if it was an "avoidance transaction" within the meaning of the general anti-avoidance rule and two of the three hallmarks of the definition of reportable transaction were satisfied.
26 As defined in s. 245(1). This definition is generally limited to tax benefits under the ITA. Note that in December 2023, the definition was expanded to include tax attributes that have not yet become relevant to the computation of tax.
27 As defined in s. 237.3(1).
28 As defined in s. 237.3(1).
29 As defined in s. 237.3(1).
30 As defined in s. 237.3(1). This includes a treatment that a person uses or plans to use in an income tax return or information return and includes a decision not to include an amount on such a return.
31 As defined in s. 237.3(1).

to an agreement between arm's length persons for the sale or transfer of all or part of a business (in an asset or securities deal) where it is reasonable to consider that the insurance or protection is:

- intended to ensure that the purchase price paid under the agreement takes into account any liabilities of the business immediately prior to the sale or transfer; and
- obtained primarily for purposes other than to achieve any tax benefit from the transaction or series.

The CRA released **guidance** on the mandatory disclosure rules on July 5, 2023 (CRA Guidance), which provides some additional clarity regarding the CRA's administrative position regarding the application of the rules and has been updated since its release. We expect additional examples to be added as the CRA's understanding of the rules continues to evolve. The following examples are of particular note in the private equity and M&A context.

The CRA Guidance states that confidential protection does not include the following:

- Standard confidentiality agreements which do not require tax advice to be confidential, such as a letter of intent that includes a confidentiality requirement.
- Standard commercial confidentiality provisions in standard client agreements or documentation, which do not contemplate a specific identified tax benefit or tax treatment.

The CRA Guidance states that contractual protection generally does not include the following:

- Standard representations, warranties and guarantees between a seller and purchaser, as well as traditional representations and warranties insurance policies, that are generally obtained in the ordinary commercial context of M&A transactions to protect a purchaser from pre-sale liabilities (including tax liabilities).
- Standard commercial indemnity provisions in standard client agreements or documentation, which do not contemplate a specific identified tax benefit or tax treatment.
- Contractual protection in the form of insurance that is integral to an agreement between persons acting at arm's length for the sale of a business where it is reasonable to conclude that the insurance protection is intended to ensure that the purchase price paid under the agreement takes into account any liabilities of the business immediately prior to the sale, and the insurance is obtained primarily for purposes other than to obtain a tax benefit from the transaction or series. Below are a few examples provided by the CRA:[32]

a. Indemnities related to existing pre-closing tax issues, or the amount of existing tax attributes (tax pools, capital cost allowance, etc.).

b. Contractual covenants or indemnities obtained by a public company purchaser from the target company and the target company's significant shareholders that are intended to ensure that the target or the significant shareholders do not take certain steps that may cause the bump denial rules to apply and that the purchaser is indemnified for the additional taxes payable if it loses the availability of the "bump" under paragraph 88(1)(d) of the ITA. This could also apply in a private corporation context.

c. Tax insurance or other contractual protection acquired regarding the purchase of taxable Canadian property from a non-resident of Canada so that the parties can complete the transaction without concern for the purchaser withholding an

32 The CRA Guidance cautions that this carve out does not extend to other insurance or protections covering specific identified tax risks (i.e., not listed in the CRA Guidance). In these circumstances, it will need to be considered whether there is an avoidance transaction and whether a hallmark is present.

amount in respect of a potential tax liability of the non-resident.

d. Contractual protection obtained in respect of the calculation of safe income on hand in the context of a pre-sale transaction involving the payment of inter-corporate dividends to a holding company to extract safe income from the target company.

e. Indemnities or covenants in favour of a purchaser and/or target in respect of Part III tax liabilities and other adverse tax consequences arising from dividends paid as part of a pre-closing reorganization.

— Standard price adjustment clauses and, for greater certainty, other price adjustment clauses that are not tax-driven (such as working capital adjustments).

— Standard contractual representations and indemnities with respect to the failure to deduct or withhold an amount under s. 215, in an arm's length situation.

— A partnership agreement containing a standard clause to the effect that, in the event of an audit of a partner, the partnership will provide reasonable assistance to that partner to help them resolve such an audit, as long as the purpose of the clause does not contemplate any particular avoidance transaction or series of transactions.

— Contractual protection obtained in a normal commercial or investment context in which parties deal with each other at arm's length and act prudently, knowledgeably and willingly, and does not extend to contractual protection for a tax treatment in respect of an avoidance transaction. This may include tax indemnities in standard provisions such as gross-up clauses in loan agreements or International Swap and Derivative Agreements and tax indemnities in employment agreements and severance agreements.

Multiple persons may have reporting obligations — it is not just the taxpayer who obtains the tax benefit that is required to report. The following persons must report:

— The specific person for whom a tax benefit results (or is expected to result based on the person's tax treatment of the reportable transaction) from a reportable transaction or series of transactions that includes the reportable transaction.

— Persons who have entered into an avoidance transaction that is a reportable transaction for the benefit of a person described in the bullet point above.

— Advisors and promoters in certain circumstances. Generally only advisors or promoters who receive contingent fees or are entitled to a fee for providing contractual protection must report. Lawyers who receive standard fees based on hourly rates should generally not have a reporting obligation.

In light of the potentially broad scope of the new mandatory disclosure rules, private equity funds, investors and their advisors should continue to monitor the CRA Guidance as it evolves. For example, at the fund formation stage, it should be considered whether any of the provisions in the LPA could give rise to a reporting obligation. In certain circumstances, the confidentiality provisions in an LPA could be a hallmark and trigger a reporting obligation (if there is an avoidance transaction) — although the confidential protection must be obtained by an advisor or promoter (or person that does not deal at arm's length with an advisor or promoter), the definitions

of “advisor” and “promoter” are sufficiently broad to potentially include a fund manager or sponsor, depending on the facts. It may be prudent to ensure that confidentiality provisions in the LPA do not prohibit disclosure of legislative or administrative reporting obligations (e.g., that there is a minimum carve out for tax reporting or filings required by law). At the portfolio investment acquisition stage, a fund should consider what due diligence, representations and warranties are appropriate with respect to whether the target has been involved in a reportable transaction; the fund should also consider whether the purchase agreement representations, warranties, covenants and indemnities fall within the statutory exceptions to the contractual protection hallmark, as well as the examples provided in the CRA Guidance of arrangements not considered by the CRA to be a contractual protection hallmark. In an exit situation, if the fund requires the purchaser to obtain tax insurance in connection with the transaction, similar consideration should be given with respect to the contractual protection hallmark.

For additional details, please refer to **A Practical Guide to the New Mandatory Disclosure Rules of the *Income Tax Act***, published by McCarthy Tétrault’s National Tax Group and current as of September 12, 2023.

Rules Impacting Investment Limited Partnerships Turn Four this Year

On December 13, 2018, Bill C-86, *A second Act to implement certain provisions of the budget tabled in Parliament on February 27, 2018 and other* measures, received Royal Assent and the amendments to the *Excise Tax Act* (Canada) (ETA) impacting investment limited partnerships (ILPs) became law. By way of background, these amendments provided the following:

— The management or administrative duties performed by the general partner (GP) of an ILP became subject to the goods and services tax/harmonized sales tax (GST/HST) effective September 8, 2017;

— ILPs became “investment plans,” “listed financial institutions” (LFIs) or potentially “selected listed financial institutions” (SLFIs) for GST/HST purposes effective on January 1, 2019; and

— ILPs which have a large proportion of non-resident investors may, subject to certain exceptions, be deemed to be a non-resident of Canada for GST/HST purposes if 95% or more of the total value of all interests in the ILP are held by non-resident members of the ILP.

Although these rules have been around for four years and are now well known to the industry, they continue to trigger technical issues that must be considered both at the time of structuring a fund and throughout the life of the fund. Some of the issues that commonly arise at structuring include: whether the fund/limited partnership is resident in Canada and whether the fund/limited partnership is a SLFI.

RESIDENCY

Determining whether an ILP is resident in Canada will have repercussions on whether supplies made in Canada to the ILP (e.g., management services) can be zero-rated for GST/HST purposes and whether the ILP is required to self-assess GST/HST on supplies it acquires outside Canada.

Under the ETA, a partnership is deemed to be resident in Canada at any time if the member, or majority of the members, having management and control of the fund/limited partnership is or are resident in Canada at that time. However, in circumstances where the deeming rule does not apply (e.g., the member who has management and control of the partnership is not resident in Canada), the ETA is silent. Presumably in such cases, the common law test applicable to corporations should apply to determine the residency of the partnership. Particular attention should be given to situations where the GP of an ILP delegates or otherwise assigns all (or part) of its duties under the LPA or Management Agreement to a third-party asset manager. In such circumstances, consideration must be given to whether the GP retains the management and control of the partnership or whether the management and control is now held by the manager. A variety of iterations of such delegation, including delegation from a non-resident GP to a resident manager and vice versa may occur and should be carefully reviewed. Although the common law test for determining a person's residency generally focuses on the place where the central management and control is exercised rather than the residence of the person exercising it, GPs and asset managers alike should ensure that the residency of the ILP has been carefully considered because incorrectly determining an ILP's residency can have significant impact on the GST/HST obligations and liabilities of an ILP and its investors.

Whereas an ILP that is resident in Canada should consider whether it can rearrange its affairs to take advantage of the rule that deems a resident ILP to be a non-resident of Canada at a particular time if 95% or more of the total value of all interests in the ILP are held by non-resident members (subject to certain exceptions) of the ILP, an ILP that is a non-resident of Canada must carefully consider whether it has a presence in Canada that can result in the non-resident ILP being subject to self-assessment rules.

SLFI

By virtue of being an investment plan, an ILP is a LFI and potentially a SLFI. A SLFI is a LFI that has, at any time during a taxation year, a permanent establishment (PE) in a harmonized province (including Québec) and a PE in any other province. For purposes of determining if an ILP is a SLFI, the term PE means any PE that the ILP is deemed to have. The deeming rule provides that an ILP has a PE in a province if:

— it is qualified, under the laws of Canada or a province, to sell or distribute its units in the particular province; or

— a person resident in that particular province holds one or more units of the ILP.

Although a large number of ILPs are SLFIs by virtue of having investors resident in multiple provinces holding units of the ILP, ILPs with investors in only one province should pay particular attention as to whether they are qualified, under the laws of Canada or a province, to sell or distribute their units in the particular province. The implications arising from an ILP being or not being a SLFI can significantly impact, among other things, how the ILP is required to determine its net tax and what its compliance obligations are under the ETA.

An ILP that is a SLFI is generally, among other things:

- required to determine its liability for the provincial component of the HST pursuant to the Special Attribution Method (SAM);
- required to file a GST/HST return on a monthly basis unless it registers;
- limited in the amount of GST/HST it can recover by way of input tax credit (ITC); and
- not required to file an Annual Information Return for Financial Institutions (i.e., Form GST111 or RC7291).

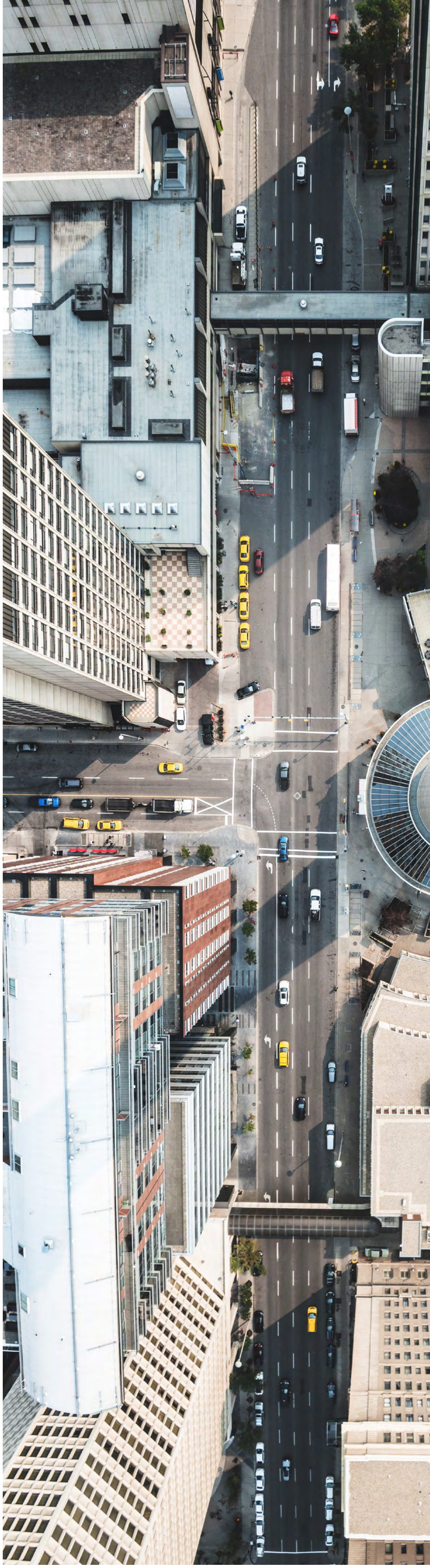
On the other hand, where an ILP is not a SLFI, it generally has limited reasons (if any) to register for GST/HST purposes. However, where an ILP that is not a SLFI registers for GST/HST purposes, it is generally:

- not limited in the amount of GST/HST it can recover by way of ITC; and
- not required to determine its liability for the provincial component of the HST pursuant to the SAM.

Finally, it may be required to file an Annual Information Return for Financial Institutions if certain conditions are satisfied. Failure to file an information return can result in severe penalties being imposed by the CRA.

The CRA has indicated that the phrase "qualified, under the laws of Canada or a province, to sell or distribute its units" should be interpreted broadly. Therefore, as stated above, ILPs with investors resident in only one province should pay particular attention to the question of whether they are qualified, under the laws of Canada or a province, to sell or distribute their units in a particular province in order to confirm their GST/HST compliance obligations.

Because the GST/HST rules impacting ILPs turned four this year leading to the expectation that CRA audits are likely to commence in the near future, private equity funds and other investment structures using limited partnerships as investment vehicles should consider reviewing their structures to prepare for an eventual CRA audit and ensure they comply with the GST/HST rules.



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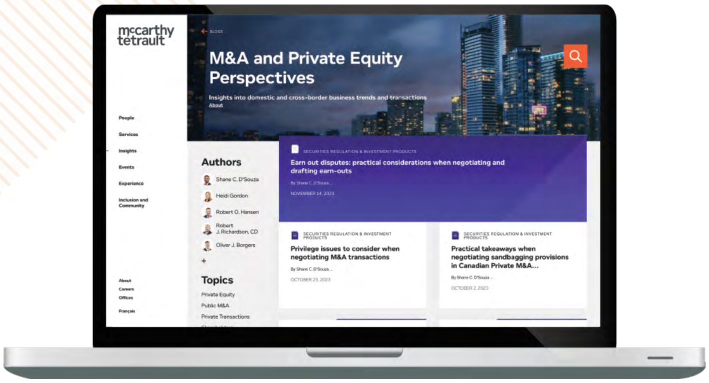

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Sources for all graphics: Pitchbook Data, Inc. | McCarthy Tétrault analysis

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