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RELATED-PARTY TRANSACTIONS: CAN YOU AVOID THE NIGHTMARE?

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ARE YOU PLANNING TO CARRY OUT A TRANSACTION? DOES IT INVOLVE A PARTY THAT IS RELATED TO YOUR COMPANY? IF SO, YOU MAY BE FORCED TO OBTAIN AN INDEPENDENT VALUATION AND THE APPROVAL OF YOUR MINORITY SHAREHOLDERS, FILE A GEOLOGICAL REPORT, AND DISCLOSE DETAILED INFORMATION. THE COSTS ENGENDERED BY THESE REQUIREMENTS CAN ESCALATE RAPIDLY OR TURN INTO A PROCEDURAL NIGHTMARE THAT COULD CONSIDERABLY DELAY YOUR TRANSACTION. HOWEVER, IT IS POSSIBLE TO AVOID OR LIMIT SOME OF THESE REQUIREMENTS BY INVOLVING A LEGAL COUNSEL SUFFICIENTLY EARLY IN THE TRANSACTION.

WHY ARE THERE SPECIAL RULES FOR THESE TRANSACTIONS?

The legislator's attention is particularly drawn to transactions in which the contracting parties are not dealing at arm's length, because of the resulting conflicts of interest. Whether the transaction is public or private, the laws under which corporations are formed protect shareholders against conflicts of interest by prohibiting directors from placing themselves in situations of conflicts of interest. They also provide that a director who is or may be in a position of conflict of interest must disclose this fact to the board of directors and refrain from voting on the transaction which is the source of the conflict of interest.

In addition, in order to better protect shareholders of corporations having offered securities to the public or shareholders of publicly held companies, the securities regulatory authorities in Quebec and Ontario have adopted a regime applicable to any transaction involving related parties.

CONCEPT OF "RELATED PARTY"

To reduce the impact of a transaction involving a related party, you must first be able to identify these types of transactions.

Some types of transactions involving related parties are obvious because they involve a corporation and a person directly related to it, which we will call a transaction with a related party of the "1st degree". An example of this is a corporation that concludes a contract with one of its own officers or directors, with a control person[1] of the corporation, or with an affiliate (for example, a subsidiary).

[3] *The term "person" for purposes of Regulation 61-101 means an individual, a corporation, a partnership, a trust, a fund, an association, etc.*

There are also transactions that one could refer to as being of the "2nd degree" in that one of the corporation's co-contracting parties is related to a person that is related to the corporation, i.e. transactions in which the corporation concludes a contract with a director or officer of:

- an insider of the corporation;
- a control person of the corporation;
- a person in respect of which the corporation is a control person; or
- an affiliated entity.

But there are also transactions between related parties, which we could characterize as being of the "3rd degree", that are more difficult to identify. In such transactions, one of the persons who is related to the corporation also has a connection to one of the co-contracting parties. These are transactions in which the corporation concludes a contract with a person one of whose directors, officers, insiders or control persons is also:

- a director, officer or insider of the corporation;
- a control person of the corporation;
- a person in respect of which the corporation is a control person; or
- an affiliated entity of the corporation[2].

The number of parties to the contract and the involvement of geographically distant persons are of little importance. One must therefore analyze the corporation's relationship with each of the parties to the contract. Given the varied and complex cases that can be characterized as being relationships between related parties, this analysis must therefore be very thorough. It would therefore be prudent to consult your legal adviser as soon as you have any doubt, to determine whether or not your transaction involves a related party.

OBLIGATIONS IMPOSED BY THE SECURITIES REGULATORY AUTHORITIES

Regulation 61-101 respecting protection of minority security holders in special transactions (**"Regulation 61-101"**) refers to three types of obligations: 1) the obligation to disclose information; 2) the obligation to obtain the approval of the minority shareholders, and 3) the obligation to obtain a valuation.

1) THE OBLIGATION OF DISCLOSURE

The obligation to disclose requires that certain detailed information respecting the transaction be disclosed in the disclosure document concerning the transaction. Some information must, for example, be included into the material change report, if you are required by the legislation to file such a report with respect to the proposed transaction. It should be noted that Regulation 61-101 also provides that the material change report must be filed at least 21 days before the closing of any transaction involving related parties, failing which the issuer must explain why a shorter period is reasonable or necessary in the news release and material change report itself. This means that the information will therefore generally be communicated much more quickly to the markets than is the case with a regular transaction.

If you are required to obtain minority shareholder approval (as discussed in point 2 below), you will also be required to provide certain detailed information in the proxy solicitation circular that is sent to the shareholders prior to the meeting at which this approval is submitted to the vote of the shareholders.

2) THE OBLIGATION TO OBTAIN THE MINORITY SHAREHOLDERS' APPROVAL

The obligation to obtain the approval of the minority shareholders requires that the transaction be approved by no less than a majority of the shareholders having no interest in the transaction and who are present by proxy or in person at a special meeting.

3) THE OBLIGATION TO OBTAIN A VALUATION

This obligation requires that the corporation provide a formal independent valuation of the corporation or the property being acquired in the transaction. This can sometimes be costly and cause additional delays.

EXEMPTIONS

The two latter obligations are however subject to a series of exemptions that enable the corporation to avoid these obligations where it meets certain criteria. For example, if the fair market value of the consideration paid to the interested parties does not exceed 25% of the market capitalization of the corporation, it will generally be exempted from these two obligations.

[2] This list is not exhaustive. For a complete list, please refer to the definitions of "related party transaction" and "related party" in Regulation 61-101 (as defined herein).

Again, the exemptions applicable to each transaction are varied and complex and must be carefully reviewed by your legal adviser to ensure the corporation does not breach the applicable regulation based on the erroneous belief that it meets the criteria for an exemption.

INTERACTION WITH THE RULES OF THE TORONTO STOCK EXCHANGE AND TSX VENTURE EXCHANGE

Unfortunately, obtaining an exemption from the requirements under Regulation 61-101 does not put an end to the nightmare. Each exchange or securities market applies its own rules in a manner that is nearly completely distinct from this regulation. Generally speaking, by itself, an exemption under Regulation 61-101 will not enable you to avoid the obligations imposed by the Toronto Stock Exchange (the "**TSX**") or the TSX Venture Exchange (the "**TSX-V**") with respect to related party transactions.

For example, under Regulation 61-101, a venture issuer is not required to obtain a formal valuation, whereas, under the rules of the TSX-V, corporations whose securities are listed on the TSX-V must nevertheless submit evidence of the value of the property or of the corporation being acquired, although they are practically all, by definition, venture issuers. Luckily, instead of an independent formal evaluation, the TSX-V sometimes accepts proof of value either through the simple filing of a valuation report by the corporation's executive officers or the filing of a geological report in applicable cases.

Another example of a difference between Regulation 61-101 and exchange or securities markets rules is that the TSX will require shareholder approval in all cases where an insider receives a consideration whose value is equal to or greater than 10% of the issuer's market capitalization. This is a lower threshold than the 25% threshold under Regulation 61-101. However, this obligation only applies to a single class of related parties, i.e. insiders.

As for the TSX-V, the requirement for shareholder approval only applies to situations in which a significant percentage of the outstanding shares of the corporation is being transferred in the transaction, situations involving the alienation of a significant percentage of the corporation's assets, or situations resulting in the creation of a new control person.

Despite the existence of policies that enable the corporation to anticipate the potential requirements that may apply to it, the exchanges or securities markets carefully review each transaction individually, and each case is unique. For this reason, it may be preferable to initiate discussions with the exchange or securities market on which the corporation's securities are listed as soon as possible, sometimes even before the conclusion of the final agreement, in order to speed up the approval.

HOW TO AVOID THE NIGHTMARE

You should consult your legal adviser at the very outset of the proposed transaction, well before the conclusion of the final agreement, and even before the conclusion of the letter of intent.

You should be aware that there may be several ways of achieving your objective and that a transaction can be structured in a way that more easily satisfies the regulatory authorities. For example, you can decide to acquire a property in whole or in part by acquiring the corporation holding the property, rather than by acquiring the property itself. On the other hand, depending on the parties involved, the rules governing related party transactions may favour one transaction over another, and the corporation should have access to this information at the negotiation stage to assist it in making its choice, or to give it a forceful argument in its negotiations. Also, in a decision rendered by the Ontario Securities Commission in the case of MI Developments Inc.[3], the Commission recognized that there was no prohibition against structuring a transaction specifically for the purpose of invoking an exemption under Regulation 61-101. Therefore, your lawyer could suggest a structure for your transaction that would avoid the difficulties described above.

The nature of the consideration to be received by the related parties will also play a very important role in the review of the transaction by the regulatory authorities, and should therefore be considered in light of the rules applicable to related party transactions before the parties decide on one form of consideration over another.

[3] *In the matter of MI Developments Inc. (September 2009), Ont. Sec. Com.*

All these factors will influence the nature of the negotiations. You should discuss every transaction in advance with your legal adviser to determine the best options available to you and to anticipate any obstacles so as to prevent them from delaying or quite literally killing the transaction... or turning the approval process into a nightmare!

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