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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

"Through private placements, businesses that want to raise money can do so without going to the considerable expense – usually $100,000 at a minimum – of developing and issuing a prospectus."

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Business Law Department, Steven Jeffery at 416.593.3939 or sjeffery@blaney.com.

RAISING MONEY FOR BUSINESSES EASIER UNDER NEW ONTARIO LAW

Michael J. Bennett, Patrick J. Cummins

A revised Ontario securities rule designed to make it simpler and less expensive for businesses to raise capital has come into effect.

The revamped Rule, which involves so called "private placements," has its roots in the October, 1996 report of the Ontario Task Force on Small Business, which made a number of recommendations, including easier access to capital, for stimulating small business development in the province.

Through private placements, businesses that want to raise money can do so without going to the considerable expense – usually $100,000 at a minimum – of developing and issuing a prospectus.

In recent years, the law in many provinces, including Ontario, has offered two exemptions from the requirement to issue a prospectus – the private company exemption, where a private company has been allowed to raise capital from up to 50 investors (often referred to as the "friends and family" exemption) and the "$150,000" exemption, where people with $150,000 to invest have been deemed sophisticated enough to make the investing decision without the need to be provided a prospectus.

Now, however, in an effort to help start-ups or established businesses generate new capital, Ontario has replaced the historic exemptions with two new ones – the Closely-Held Issuer Exemption and the Accredited Investor Exemption -- by amending OSC Rule 45-501.

The Closely-Held Issuer Exemption allows closely-held companies to issue shares or other forms of securities in the company on a prospectus-exempt basis until the company has raised a total lifetime limit of $3,000,000. The company is obliged to provide each investor (unless there are only five or fewer), with a prescribed, standardized one-page information statement at least four days before making an investment.

[Closely held means no more than 35 investors exclusive of (a) any directors, officers, employees and consultants who are issued shares or other forms of securities in the company as part of their compensation and (b) any "accredited investors" as described below.]

The Accredited Investor Exemption permits companies to raise on a prospectus-exempt basis any amount of investment capital from investors who qualify as "accredited investors". The new Rule contains an extensive definition of "accredited investor," which includes many institutions, businesses with net assets over $5,000,000 and individuals who meet certain financial-asset or net-income tests [eg., for individuals, net financial

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assets of at least $1,000,000 (which can be on a combined basis with a spouse) or annual pretax income for the most recent two years of at least $200,000 (or $300,000 if combined with a spouse), as well as a reasonable expectation of achieving at least that income level in the current year]. Accredited investor criteria apply only at the time of the trade and there is no obligation on the company to monitor an investor's continuing qualification as an accredited investor.

Formal disclosure documents likely will be required for sales of securities of closely held issuers or sales to accredited investors. Generally, such investors will have the right to take legal action if there are misrepresentations in the disclosure documents. As well, companies that complete sales to accredited investors will be required to file reports with the Ontario Securities Commission.

While the new Rule transforms Ontario's private placement regime to one that is more analogous to the regime in the United States, it will make Ontario significantly different from the other provinces and territories. There has been no nationally co-ordinated approach to the introduction of new rules for private placements and each province and territory will have its own set of rules. The British Columbia and Alberta Securities Commissions recently proposed new capital raising rules which follows a different approach than OSC Rule 45-501 and include a new broader private issuer exemption. ■

Patrick J. Cummins of Blaney McMurtry's securities law group provides ongoing advice and services to public and private companies and mutual fund companies with respect to regulatory compliance, financing issues and securityholder communications.

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SAVE YOURSELF SOME TIME, MONEY AND HEARTACHE...

Joan H. Garson

I am seeing a phenomenon in my practice that is giving me some cause for concern – concern because clients are weakening their positions unnecessarily.

The phenomenon I am talking about is the occasional tendency of a party to a written, signed business agreement to try and work out differences with the other side without even so much as re-reading the agreement to see whether it covers the issue in question or provides a process for resolving that issue.

There is obviously nothing wrong with parties trying to work out differences in a mature, reasonable and constructive way.

My experience suggests, however, that if there is a formal agreement in place, tackling issues without reference to it can be wasteful, counter-productive and, ultimately, harmful to the best interests of the negotiating party.

A well-crafted business agreement, by definition, anticipates issues that may arise and provides for a resolution before they arise.

Anybody who has paid for professional counsel to develop an effective agreement has therefore already spent a good deal of time, effort and money identifying potential problems and mutually acceptable ways of sorting them out.

Any hesitation about revisiting the agreement when issues do arise amounts to a hesitation to realize full return on the investment that has been

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made in developing the relationship to begin with, let alone full return on the investment that has been made in developing the agreement itself.

If differences crop up in your relationship with a business associate with whom you have a formal agreement, beware the understandable instinct to go "off line" in an effort to resolve the matter informally and non-confrontationally.

At a rock-bottom minimum, re-read the agreement to see if it covers the circumstances. Beyond that, call the lawyer who has helped you develop the agreement to help you explore the courses of action open to you and to think through the best approach.

Clients often fail to realize that as they exchange emails with the "other side" as to the facts, they have unwittingly created a paper trail that may later cause them grief. As a result, it is wise to discuss a strategic approach early on with the lawyer who drafted the relevant agreement, after reviewing the agreement.

The financial payback, and the payback in terms of sustained stature in the relationship, can be significant.

A recent case from my own practice provides a good example. Our client spent a great deal of time and money negotiating a lengthy service agreement. When the facts changed, the client was loath to become confrontational, but instead attempted to rely on the good will of the other party to address the changed circumstances. Months passed. Eventually I received a call from the client, and we reviewed the agreement and the legal remedies. A firm approach based on the remedies contained in the agreement resulted in a resolution. It also resulted in a shift back to our client of at least a portion of the power in the relationship. ■

INCOME TAX IMPLICATIONS OF EMPLOYEE STOCK OPTIONS GENERATING MANY QUESTIONS

Paul L. Schnier

The treatment of employee stock options under the *Income Tax Act* has been a subject of great interest over the past year or so. I don't know whether this has been coincidence, the result of economic times, or the markets dictating this form of compensation over cold, hard cash. Irrespective of the reason, however, a review of the tax treatment of employee stock options may be both timely and beneficial for readers, employees and employers alike, who are dealing with this tricky executive compensation issue.

As is often true under the *Income Tax Act*, there are two sets of employee stock option rules – one for corporations in general and another for Canadian-controlled private corporations (CCPCs). The CCPC rules contain greater incentives for employees.

Under the general rules, when an employee, including an officer or director, receives a grant of a stock option in the corporation that employs him or her, or in a related corporation, there is no taxable benefit at the time of the grant. The taxable benefit to the employee arises at the time that he or she exercises the option. The amount of the taxable benefit is the difference between the exercise price and the fair market value of the stock at the time of exercise.

This benefit must be included in the employee's income regardless of whether or not he or she sells the stock. The employee's adjusted cost base for the stock for future gains purposes will be the fair market value of the stock at the time of exer-

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Paul Schnier chairs Blaney McMurtry's tax group. He restricts his practice to income tax law with emphasis on tax planning and implementation and advising as to the tax consequences of proposed transactions. He has advised a variety of public and private corporations on numerous domestic and international undertakings.

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cise. Any proceeds received by the employee for the stock over and above this amount will usually be treated as a capital gain.

The amount of the benefit is reduced if two conditions are fulfilled – (a) if the strike price (the amount at which the option may be exercised) is not less than the fair market value of the stock at the time the option is granted and (b) if the employee is dealing at arms length (as defined in the *Income Tax Act*) with the corporation granting the option.

Where these circumstances are both present, the amount of the benefit is reduced by 50 per cent so that the effect is to tax the benefit as if it were a capital gain. Furthermore, an additional benefit has been enacted recently so now, if the two conditions above are met, an employee who exercises rights under a stock option grant can defer the tax consequences until the time the stock is sold. This deferral is available in respect of a maximum of $100,000 worth of stock (at the time of the grant) in each year of vesting. To qualify as a CCPC, a corporation must be Canadian, private, and not controlled by public corporations, non-residents or any combination thereof.

If a corporation that qualifies grants an option to an arms length employee, the general rules described above are modified in two ways. First, the time at which the benefit is included in income is when the stock is sold, not when the option is exercised.

Second, even if the strike price is less than the fair market value of the stock at the time the option is granted, the amount of the benefit will still be reduced by 50% if the employee exercising the option holds the stock for at least two years before he or she sells it. The budget resolution has no impact on CCPCs since the inclusion of the benefit in income is deferred until the stock is sold in any event.

Once again, these special CCPC rules will only apply if the corporation and the employee are dealing at arms length (i.e. controlling shareholders need not apply). ■

BLANEYS NEWS

Jill E. McCutcheon has become a partner in the firm. Jill, who was called to the Bar in 1989, practises corporate/commercial law with particular focus on insurance business and regulatory law, including e-commerce and privacy issues.

Eric Golden has become a partner in the firm. Eric practices commercial and general civil litigation. He was called to the Bar in 1996.

Shawn Wolfson, following completion of the Bar Admission Course in February, 2002, has joined the firm's Real Estate Group.

Blaneys on Business is a publication of the Business Law Department of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com. Legal questions should be addressed to the specified author.

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