Income Trusts: Where Do We Go From Here?

Ever since Finance Minister Jim Flaherty’s “Halloween Surprise” on October 31, 2006, the income trust sector has been facing a cloudy future. The prospect of losing its cherished tax status was distressing news, even if it was not entirely unexpected. Furthermore, the long wait until the new tax rules would come into effect in 2011, while giving trusts ample time to prepare for the new regime, created a climate of some uncertainty.

Before the Flaherty announcement, trusts had enjoyed booming popularity. They became a desirable vehicle in the 1990s for retail investors – particularly investors who were past their prime capital formation years – who were seeking a steady stream of income. Trusts subsequently attracted an institutional following as mutual funds began including them in their portfolios.

The turn of the millennium witnessed an acceleration of their growth as more and more companies sought out conversion to a trust to shelter themselves from corporate tax rates. At their peak, income trusts constituted a market value of over $200 billion. The party finally came to an end in 2006, when the prospect of large companies like Bell Canada converting to a trust set off alarm bells in Ottawa and prompted Flaherty’s decision to place trusts on the same tax footing as corporations.

**M&A Activity**

In the first nine months after the announcement, there was a flurry of activity in the sector. The sudden and very significant drop in the valuation of trusts made them attractive takeover targets. Acquirors with ready access to debt seized on opportunities to employ private debt.

**Reverting to Corporate Status**

Since then, the focus in the sector has shifted. Credit markets have been severely disrupted in the past year, and tightening credit has made it harder for companies to undertake new mergers and acquisitions. With the decline in M&A activity, some trusts have begun to look at conversion to corporate status well before the 2011 deadline.

For example, TransForce Income Fund, one of the largest trusts in the country, became a corporation again in the middle of May of this year. Its decision to convert back to corporate status was motivated by a desire for greater financial flexibility than was allowed under the trust structure: TransForce has an aggressive growth strategy which it pursues, in large measure, by acquiring smaller companies. Under the growth limitations imposed by trust rules, it would have been severely hampered in its ability to make acquisitions using securities as payment since, as a cash distributing trust, its debt capacity is more limited. With an eye on future acquisition targets, TransForce decided that the time was ripe to assume a corporate structure to maximize its financial flexibility.
Similarly, Aeroplan Income Fund also has converted to a corporate structure. By converting to company status, the Fund was able to eliminate limits on trusts regarding the proportion of foreign ownership. These limits existed before the 2006 announcement, and it is only now that Aeroplan has started to bump up against them.

Trusts that are contemplating conversion need to consider the extent to which they can maintain themselves as a high paying dividend corporation. If not, they may face substantial turnover in their securityholder base as income-seeking investors may exit. They also need to consider whether they have a sufficient market capitalization for institutional investors and, if not, whether they can achieve that by 2011 through growth or a merger.

DEFERRAL OF CONVERSION

For most trusts, the decision to maintain their current structure is simple: being a trust confers a significant tax advantage that they need not relinquish any earlier than necessary. Given prevailing market conditions, it may make sense for trusts to wait for more favourable conditions in anticipation of receiving offers from potential bidders.

In July 2008, the federal government released draft legislation that is intended to facilitate the restructuring of income trusts and their conversion to corporate form. The rules, if enacted as proposed, would generally allow existing income trusts to convert on a tax-efficient basis during a five-year window ending December 31, 2012.

There are two methods of conversion permitted under these proposals. The first method (a Unit-for-Share Exchange) involves the exchange of units of an income trust for shares of a corporation. The second method (a Share Distribution) involves the distribution to the trust’s unitholders of shares of an underlying corporation. While a Unit-for-Share Exchange may in some circumstances be more complex to effect than a Share Distribution, it may also carry some advantages over the Share Distribution alternative, such as allowing the resulting corporation to inherit many of the tax attributes (such as loss carry-forwards and undeducted issue expenses) of the trust.

THE LAWYER’S PERSPECTIVE ON TRUSTS

The future prospects for the sector have been severely diminished. Ultimately, almost all trusts (other than REITs) are expected to be sold or to convert to corporate form; thus, the issue facing them is mainly one of timing. For most business trusts, that conversion will take place by 2011, although for some non-REIT real property-based trusts or energy trusts that have significant shelter from tax pools, the conversion may be later than that date.

Consequently, with the publication of draft conversion rules, counsel cannot afford to simply defer consideration of the conversion issue. It is important to consider now what options are available to a trust and how the trust will deal with the ultimate evaporation of its tax advantage less than three years from now.

When advising the board of an income trust, general counsel must be fully cognizant of the strategic implications of a decision to convert. No matter when a trust takes the conversion step, if its distributions are diminished, it may experience a short-term drop in its price as a result. Counsel should ensure that the trust has obtained good financial, market and legal advice to support its decision, and has thought through such issues as the level of dividends it plans to declare once the trust becomes a corporation.

This is bound to be a sensitive issue. Since dividends can generally be expected to be lower than unit distributions, conversion to a corporation could cause a significant change in the entity’s investor base.

A key part of this process is the consideration of the use of the tax attributes of the entities in the trust structure, the effect of conversion on external indebtedness – including both bank debt and convertible or other outstanding debt – as well as the cost implications of conversion itself. The costs and the effect of the transaction on employees and employee compensation arrangements should also be considered.

The need to ensure a thorough and well-documented process becomes even stronger if a trust decides to convert before 2011. In that case, since it would be foregoing a tax advantage, it is incumbent on the trust to demonstrate to unitholders that it has undertaken due diligence in considering alternatives and in making its ultimate choice to convert early.
LOOKING AHEAD

There is little clarity as to when the credit crunch will be over, but once it is, M&A activity will certainly heat up. In anticipation, trusts need to consider their options carefully and address the best interests of their unitholders. General counsel must ensure the conversion process is properly executed and, in addition to considering the factors set out above, should consult a tax expert as the draft conversion rules are highly detailed and technical.

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Defamation in the Internet Age

The astonishing growth of the Internet over the past 10 years has brought profound changes to the business world. It has also had a great impact on the law, raising new issues that were almost unimaginable before the Internet became a widespread tool for communication. An important issue for corporate counsel is that of defamation. As is well known, the Internet has the power to build reputations and launch careers overnight; yet, it has a darker side as well – the power to damage reputations and destroy careers just as quickly. Lawyers need to be aware of this new development, since we have entered uncharted territory that poses significant risks for companies and their employees.

Power has shifted

Fortunately for the legal profession, much of the framework that defines defamation remains unchanged. Individuals – including corporate entities – have the right to a good name, and not to have their reputations disparaged without legal justification. Not surprisingly, then, the law governing defamation applies to the use of Internet communications under the same basic principles as other forms of communication. Protecting an individual’s good name must, of course, be balanced against the right to freedom of speech, and the tension that exists between the two interests continues unabated in the Internet Age.

What has changed, however, is the ease with which defamatory statements can be made. Email, websites, bulletin boards and chat rooms have given individuals unprecedented power to defame. These innovations provide a single person with the means to damage a reputation instantly, in relative anonymity, while reaching a potentially global audience. As a majority of the Ontario Court of Appeal noted in Barrick Gold Corp. v. Lopehandia, large corporations no longer automatically hold an advantage in a reputational battle. With the Internet, every individual is a potential David in his struggle against Goliath.

The increased ease of defamation has brought with it a correspondingly elevated potential for harm. While newspapers or television broadcasts have relatively limited circulation and are traditionally confined to circumscribed geographies, defamatory statements on the Internet are subject to no such limitations. They can be copied, linked and repeated endlessly, and they can be accessed anywhere in the world where someone can log onto the Internet. With the Internet, defamation now knows no borders, and this raises one of the thorniest issues in defamation law: jurisdiction. Whereas jurisdiction was previously a relatively simple matter of determining where a malicious or defamatory statement was published and where it was read, the Internet has rendered the process of determining jurisdiction considerably more complex. Not only can such a statement be disseminated anywhere in the world, it can also be uploaded anywhere as well. The courts are only now beginning to address the novel issues this raises – from “forum shopping” around the globe by those with a grievance, to the ability to enforce judgements in jurisdictions other than where a case was heard. Taken together with the ease of publication, this jurisdictional complexity makes the Internet that much more “defamation-friendly.”
TECHNOLOGY IS CHANGING, AND THE LAW NEEDS TO ADAPT

Canadian courts have recognized this new reality in assessing defamation cases. They have acknowledged that an intention to inflict maximum harm on a plaintiff by publishing to a global audience merits a corresponding increase in the damages awarded. They have also decided that the anonymity of the Internet is relevant, since its impersonal nature may contribute to the believability of a defamatory statement.

Yet the courts are also struggling. Their decisions have typically been narrow in scope, eschewing general principles to rely instead on highly specific, fact-based analyses. The courts’ hesitation derives, in large measure, from the rapidity with which communications are evolving. They have little case law to draw on and are facing an issue that is, in many ways, beyond their current scope: when a technology changes society as fast and as significantly as the Internet has, courts face new challenges. Ultimately, the response may be best left to the legislatures, not the courts, to work toward consistency and uniformity among jurisdictions. Meanwhile, the courts will continue to grapple with the application of older principles to challenging new scenarios.

GENERAL COUNSEL MUST BE PROACTIVE

In such an uncertain environment, it is all the more important for general counsel to be vigilant. Not only are the stakes now potentially higher, the ease with which defamatory statements can be made increases the likelihood that such statements will occur. People publishing through a website, discussion group or email may incorrectly view such statements as a less formal type of communication and, armed with little or no understanding of the law, refrain from the editorial and legal checks that are afforded to professional media outlets. In addition, in many cases it is difficult to identify who made a statement on the Internet and tracing an author may be costly and time-consuming.

This applies as much to committing libel as to defending against it. Employees with no legal training may expose their company to legal liability and damages with reckless emails or web postings that they mistakenly believed did not constitute publication. So, counsel must ensure that everyone in a company understands what they may and may not communicate on the Internet. It may be particularly challenging to control statements by disgruntled or former employees, but counsel can take steps to address this through policies, Codes of Conduct, and in some cases confidentiality agreements.

Greater vigilance also boils down to speed of response. Speed is vital not only because communications spread so fast on the Internet, but also because a number of issues must be considered in addressing a potentially defamatory statement. Initially, the issue is a legal one: Is a statement in fact defamatory? Or is it true, fair comment or protected by a legal privilege? This issue raises several other inquiries: What are the notice and limitation periods under the relevant legislation? Does the notice period for other media apply to Internet communications and what is the window of opportunity for launching a lawsuit? What other remedies may be appropriate and available to address or respond to a perceived harm?

Once the legal questions have been answered, counsel must then consult with senior management to assess an appropriate response. The ensuing damage simply may not be enough to warrant getting a statement removed, and legal action may only make things worse for an entity’s reputation: a lawsuit can be complex, costly and lengthy and, in the end, may generate negative publicity far in excess of that associated with the original statement. These are strategic corporate questions that may outweigh narrower legal considerations.

WHERE ARE WE HEADED?

The use of the Internet continues to grow around the world, and the most troubling aspect of this growth for defamation law is jurisdictional. Not only is technology evolving faster than the law, but it also respects no national boundaries. Some Canadian courts have recently commenced the task of moving the country’s defamation regime closer to that of the United States, and a growing compatibility between jurisdictions may some day reduce the difficulty of enforcing foreign judgements. Yet the challenge remains: electronic communication is proliferating and has the potential to do untold harm, whatever (and wherever) remedies might be available after the fact.
For general counsel, then, the ultimate answer to such a challenge lies in proactivity coupled with vigilance. A proactive approach to potentially harmful electronic communication includes addressing the use of electronic communication in corporate policies, Codes of Conduct, and confidentiality agreements, where necessary. It also means educating employees on the general principles and protocol for electronic communications and establishing procedures for being alerted to potential problems – whether they originate from within or from outside the company. By being vigilant about such communications, general counsel will be able to react quickly when issues do arise, consulting with counsel and senior management to devise the most appropriate strategy.

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Canadian M&A Gets an International Flavour

While the volume of big ticket M&A transactions appears to be on the rise as we enter the third quarter of 2008, it is unlikely that we will see the same number of deals as in prior years. However, certain segments of the Canadian M&A market are enjoying robust levels of activity. For example, international buyers have been very active in pursuing Canadian companies and assets or making significant equity investments. We have advised on a number of these transactions and our experience strongly suggests that this trend will continue.

As has often been the case in the past, U.S. buyers have been active in the Canadian M&A market over the last six months but we are also seeing strong activity levels from overseas purchasers. The Canadian resource sector continues to attract a large amount of international investment as have the financial services and real estate sectors. In addition, overseas purchasers are actively pursuing significant opportunities in a variety of other industries such as Canadian telecom, technology, pharmaceuticals, life sciences and media/entertainment.

**STRATEGIC BUYERS AND SOVEREIGN WEALTH FUNDS**

Not only has the current M&A market become more international, but the mix of strategic and financial buyers has also shifted. Given the downturn in the global credit markets, private equity investors and other financial purchasers have seen their access to credit diminish. This, in turn, has made it more difficult for these types of investors to apply the degree of leverage they require to achieve their targeted returns. Accordingly, strategic purchasers who can fund transactions out of cash flow, off of their own balance sheets, or with their own securities, are much more competitive in the current environment.

Sovereign wealth funds (SWFs) have also become increasingly active in the international M&A market. SWFs are typically formed to invest the sovereign wealth of a nation or state. Given the dramatic increase in oil prices, SWFs in the Middle East currently have very significant amounts of capital to invest. As the Middle East and South East Asian regions do not generate enough attractive opportunities to absorb all of this capital, some SWFs have adopted a global perspective and have been prominent in many high-profile international transactions over the last few months. Examples include significant investments in Merrill Lynch, Citigroup, Ferrari, Sony and Cirque du Soleil, and the acquisition of Barneys New York, Doncasters, Northrock and Prime West.
Many SWFs and some strategic buyers are seeking some exposure to the North American markets, and view assets in some sectors, such as financial services and real estate, as being currently well-priced. However, there is a perception among some international players that the United States is not as welcoming of foreign investment as other jurisdictions, and that perception may be deterring investment in the U.S. by some overseas investors. We believe that Canada can expect to see increased levels of foreign investment for this reason.

**LONG-TERM INVESTMENT HORIZON AND CRITERIA**

Having advised a number of international enterprises in connection with Canadian acquisitions, we have observed that overseas strategic purchasers and SWFs often have a longer term investment horizon as compared to traditional private equity purchasers, and are not as focused on an exit transaction in the first three to five years following an acquisition. Further, as international purchasers usually do not have to lever the transaction to the same degree as traditional private equity purchasers, their requirement to generate significant earnings growth over the near term is not as pronounced.

Instead, international purchasers are often attracted to long-lived assets, access to technological innovation, prominent brand names, strong management teams and North American distribution channels. Further, SWFs that have accumulated capital as a result of hydrocarbon resources in their home jurisdiction are also looking for diversification away from the oil & gas sector. Hospitality, automotive, aerospace, health care, financial services, media and entertainment are but a few of the sectors that have attracted significant SWF investment.

Despite the fact that SWFs have significant pools of capital to invest, they will not overpay for assets. The international deal teams with whom we have worked are very experienced, sophisticated and highly disciplined. Like all investors, they are focused on value. Simply stated, these types of purchasers will not transact unless the deal meets their investment criteria. International purchasers are quite prepared to walk away from a transaction if satisfactory terms cannot be reached or conditions satisfied, and there is not the same level of anxiety in connection with a broken deal that can exist among North American parties.

**REGULATION OF FOREIGN INVESTMENTS**

Although Canada’s regulatory regime regarding foreign investment is undergoing some changes, we believe Canada continues to enjoy a reputation as a country that welcomes foreign investment. Guidelines have been published regarding the application of tests under the *Investment Canada Act* for investments by SWFs, and the federal government recently blocked the sale of certain Canadian geospatial assets to U.S.-based Alliant TechSystems Inc.

Nonetheless, the Canadian government has confirmed its policy objective of ensuring that Canada is a preferred destination for both domestic and foreign investment. In June, the Competition Policy Review Panel released its report containing a number of important recommendations to improve the competitiveness and economic performance of the Canadian economy. The Panel clearly supports continued foreign investment.

**ADVISING INTERNATIONAL PURCHASERS**

International purchasers are wise to engage experienced deal counsel to help them navigate Canada’s *Competition Act* and *Investment Canada Act*. In addition, purchasers in certain sectors such as banking, telecom, transportation, media and uranium production will also have to be mindful of sector-specific legislation such as the *Bank Act* (Canada), the *Broadcasting Act* (Canada) and *Telecommunications Act* (Canada). Purchasers should also obtain Canadian taxation advice early in the process. Co-ordination of that advice with the corporate and securities analysis is an important element in ensuring that the transaction is structured in an efficient manner.

In our experience, many international purchasers (especially those that have undertaken transactions subject to U.S. or U.K. law) will generally be familiar with the principles that underlie many of the Canadian laws applicable to an acquisition transaction. However, some elements of Canadian corporate and securities law – such as the availability of plans of arrangement to effect an acquisition, the need for resident directors and our employment laws – are unique in some respects. Counsel advising international clients should take the time at the outset of a transaction to highlight these differences.
We have also found that cultural and legal differences are rarely an impediment to completing a successful acquisition in Canada. While we have noticed that international strategic buyers and SWFs appear to prefer negotiated transactions, which enhances access to the target management team and permits a deeper due diligence investigation, there is no reticence to going hostile in appropriate circumstances.

There is also a tendency for the executives of some international buyers to expect significant, direct peer-to-peer interaction with the leadership of the target company. Canadian counsel should advise their clients at the outset about the role of intermediaries and the board of directors of a target in a significant corporate transaction, especially in circumstances where an “independent” or “special” committee of the board has been established.

**LOOKING AHEAD**

We expect that international strategic purchasers and SWFs will be increasingly active participants in the Canadian M&A market. There are excellent investment opportunities in this country combined with a regulatory framework that welcomes inbound investment. Further, there should be more Canadian visibility in the international community as SWFs and other foreign investors set up shop in North America and Canadian financial intermediaries travel further afield to promote investment opportunities in this country. It will be very interesting to see to what extent international buyers pursue opportunities in the income trust sector, as these types of vehicles appear to satisfy a number of the investment criteria that international strategic investors and SWFs have enumerated as being important to them.

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Mounting Health Care Costs Drive Outsourcing Initiatives

Governments at all levels are placing greater emphasis on fiscal accountability in the MUSH (Municipalities, Universities, Schools and Hospitals) sector. This increased attention has led to a specific focus on keeping health care costs low. Such a focus is not surprising, given that health care sector costs in Ontario, for example, account for almost half of the provincial budget.

Indeed, 46 cents of every program dollar in the 2008 Ontario budget is being spent on health. Proposed expenditures in the health sector for 2008-2009 would total $40.4 billion, rising to $44.7 billion in 2010-2011. In Alberta, spending on health care is projected to be $13.2 billion in 2008-2009, rising to $14.3 billion in 2010-2011. In Québec, budget estimates for 2007-2008 allocated $23.8 billion to health and social services. The 2008-2009 budget projects $56.9 billion in spending on health and education for that fiscal year. The recent report of the Québec task force chaired by former Québec Health Minister, Claude Castonguay, observed that the growth in health care expenditures in that province exceeds the anticipated growth in the economy, thereby rendering government revenues insufficient.

In light of mounting fiscal pressures, new accountability mechanisms in the health care sector require hospitals to achieve and maintain a balanced budget. As a result, hospitals are increasingly outsourcing functions outside of their core health care expertise. In fact, many aspects of our health care system are already being provided by the private sector. A 2006 report of the Canadian Institute for Health Information (CIHI) indicated that private sector spending represented nearly 30% of health expenditures in Canada. Private sector expenditure was expected to reach $47.1 billion in 2007, according to CIHI’s report, National Health Expenditure Trends.

In Ontario, we have seen such outsourcing occur in four key areas.

**CAPITAL PROJECTS**

Health care outsourcing has become increasingly important for capital projects. Infrastructure Ontario has identified a five-year $5 billion investment plan to renew and build new hospital facilities with private expertise and financing. National and international consortiums have been established to respond to this unprecedented reinvestment in Ontario’s public capital infrastructure. In 2007, Québec announced infrastructure spending of $30 billion over five years, while in Alberta, a 20-year strategic capital plan earmarking $120 billion to improve infrastructure, including hospitals, was announced earlier this year. In British Columbia, $5.8 billion was budgeted for infrastructure spending in 2008-2009, with similar spending anticipated for the 2009-2010 and 2010-2011 fiscal years.

**BACK OFFICE FUNCTIONS**

Many hospitals are outsourcing “back office” functions, including their purchasing, warehousing, human resources and finance departments. In our experience, hospitals are most frequently looking to shared services corporations to take on these functions. Such corporations are formed expressly for this purpose and develop specialized expertise, for example, in strategic sourcing.
Shared service providers generally offer their services to multiple health care institutions and therefore are able to offer purchasing and volume discounts. These arrangements result in significant savings that can be applied to a hospital’s core patient care function, or for financing new equipment such as sophisticated information technology systems that are being developed by the private sector.

While these arrangements have resulted in a reduction in inventory costs and spoilage, human resources savings have not yet been realized due to the reluctance of various levels of government to outsource unionized jobs. Additionally, the creation of shared services arrangements has resulted in potential conflicts at the board level. Shared service corporation boards are comprised of representation from member institutions. This means that board members represent both the interests of the shared service corporation as well as the interests of member institutions. These member institutions, who are the boards’ customers, may be called upon to provide supplemental funding to the shared service corporation in the event of a shortfall.

**E-HEALTH RECORDS**

The Ontario Ministry of Health and Long-Term Care has identified a province-wide e-health strategy as one of its priorities. The use of electronic health records and repositories may dramatically change the way that Ontario provides health care, enabling more timely, complete and accurate information exchanges between health service providers.

The 2008 Ontario Budget pegged investment in electronic health records at $47 million for this year and climbing to $239 million in 2010-2011. We are working with hospitals to build and maintain shared network and storage solutions for electronic diagnostic imaging records and are relying on private sector entities to provide the requisite technology and expertise. British Columbia allocated $30 million over five years to this initiative, beginning in 2005. The province expects an additional $120 million from Canada Health Infoway over the same five-year period.

**PATIENT CARE**

Finally, patient care itself is increasingly being outsourced to the private sector. Lab work and diagnostic imaging work are both increasingly being outsourced to companies that provide such services. In Canada, provincial health insurance plans cover only those health care services that are determined to be “medically necessary.” Since there is no universal definition of “medically necessary” applicable across all provinces, each province has the discretion to determine which services will be considered “medically necessary” and hence be insured. This discretion has resulted in the scope of publicly insured services differing from province to province, which, in turn, has resulted in the scope of privately provided services varying from province to province.

Moreover, the difference between what governments say they will fund and what the public demands as the best health care is becoming more and more remarkable. The basket of health care goods that provincial governments are providing has remained modest and stagnant for several decades due to crippling cost pressures, despite the evolution of clinical science in terms of technology, procedures, drugs, pharmacology and devices.

Furthermore, there is no federal or provincial legislation which prohibits insured persons from directly or indirectly paying for uninsured hospital or physician services which are clinically “medically necessary.” Indeed, the Supreme Court of Canada’s decision in *Chaoulli v. Québec* supports the private provision of services which are not available through provincial health insurance plans.

**PRIVATE SECTOR OPPORTUNITIES AHEAD**

Given the shift in demographics towards a growing elderly population – it is estimated that the number of seniors in Ontario will double in 15 years – coupled with increasing sustainability pressures, we expect to see significant growth in the private sector provision of both publicly- and privately-funded health care.

In addition, we anticipate significant fundamental structural changes in the Canadian health care system. The platform for the delivery of health care services is broadening to include the provision of home-based health care services in addition to the strictly institutionalized provision of such services, and the technological advances that support the evolution of medical science continue to expand. These changes will present unique opportunities for the private sector to fill the breach between health care services that are considered “medically necessary” and are therefore publicly funded, and those services that are not publicly funded but may be made available privately.
Canada is open for business for the private sector to narrow (if not fill) the gap between what governments can offer and what the public demands. Private health care providers have been expressing a great deal of interest in Canada recently. For instance, private long-term health care providers are looking to get into private home health care in Canada. Likewise, major drug distributors are looking to ramp up their Canadian acquisitions.

Private providers looking to expand their interests in the Canadian market need to bear in mind that the health industry is highly regulated in Canada. Compliance with such a steep regulatory burden requires sophisticated legal counsel who are familiar with the applicable law and policy, and who can assist organizations in identifying and exploiting potential entrepreneurial opportunities.

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