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BusinessLawBrief

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Our first article is an overview of how flow-through shares are used to attract investment in mining and oil and gas companies operating in Canada. Greg McIlwain unravels the mysteries that surround this unique form of financing, providing clear answers as to how flow-through shares work and why they may or may not be the right vehicle for a given issuer or investor.

In our next piece, Craig Manuel reviews the harmonization of the many and varied exemptions from the prospectus and registration requirements scattered throughout provincial securities legislation. Craig summarizes some of the more useful exemptions under the newly harmonized securities laws and discusses the related filings and fees.

Patrick Westaway then cautions against signing a share purchase agreement in advance of closing or otherwise granting a right to acquire shares of a Canadian-controlled private corporation without first considering the impact that this may have on the subject corporation's tax liability.

Our final article is a call for businesses to beat the rush and audit internal control systems sooner rather than later. David Debenham warns that *Sarbanes-Oxley* is a sign of things to come in Canada and that courts are already holding companies to account for failing to detect employee fraud.

Flow-Through Shares: An Attractive Opportunity for Investors and Junior Mining and Oil and Gas Companies

Flow-through shares allow companies to finance Canadian exploration or development by renouncing income tax deductions applicable to such activities to investors. In a typical flow-through share financing, investors subscribe for flow-through shares of a company and the company uses the consideration to incur eligible exploration or development expenses. The company then renounces these expenses to the investors, allowing the investors to deduct close to the entire subscription price from their taxable income. The investors' cost base in the flow-through shares is deemed to be nil and taxation is deferred until the flow-through shares are sold, at which point investors realize a capital gain.

Flow-Through Shares

Flow-through shares are generally common shares of the company undertaking exploration and development activities. Flow-through shares must be issued pursuant to an agreement between the investor and the company whereby the company agrees to incur, during a specified time period, eligible expenses in an amount not less than the consideration for which the share is to be issued. Apart from the flow-through share agreement and associated tax benefits, flow-through shares are identical to non-flow-through shares of the same class.

Eligible Companies

Flow-through shares must be shares of a principal business corporation. This generally includes companies whose principal business is the exploration or development of mineral or oil and gas resources, including mining, drilling, refining, processing and certain other related activities.

Eligible Expenses

Expenses eligible for renunciation to flow-through share investors include Canadian Exploration Expenses and Canadian Development Expenses. These terms are defined broadly enough to encompass the majority of

exploration and development expenses incurred by companies exploring and developing mineral or oil and gas resources in Canada. The total amount of eligible expenses renounced by a company under a flow-through share agreement must not exceed the consideration received by the company for the particular flow-through shares.

Timing of Expenses and Renunciation

The specified time period for incurring eligible expenses begins on the day the flow-through share agreement is made and ends 24 months after the end of the month that includes that day. For example, a company entering into a flow-through share agreement in March, 2006 has until March, 2008 to incur eligible expenses. The company must then renounce eligible expenses before March of the first calendar year that begins after this period. For example, expenses subject to a flow-through share agreement entered into in March, 2006 must be renounced before March, 2009.

A company may not renounce expenses incurred before the flow-through share agreement is entered into. Generally, a renunciation can only be made after expenses are incurred pursuant to the flow-through share agreement; however, a “look-back rule” enables a company to renounce eligible expenses effective for the year the flow-through share agreement was entered into if the expenses are incurred in the following calendar year and renounced on or before March 31 of that year. For example, if a flow-through share agreement is entered into in March, 2006, expenses incurred in 2007 may be renounced effective December 31, 2006, provided the renunciation is made on or before March 31, 2007. Most public issues of flow-through shares rely on the look-back rule. Once such expenses are renounced, the company must incur the expenses during the year or investors will be reassessed and amounts renounced but not incurred will be added to their incomes. In order to discourage abuse, companies are required to pay interest, in the form of a tax, on amounts renounced but not

The principal advantage of flow-through share investments is the ability to pass tax deductions on to investors. These tax deductions allow flow-through shares to be issued at a premium.

yet incurred. An additional tax applies to any unspent balance of renounced funds at the end of the year.

Advantages

The principal advantage of flow-through share investments is the ability to pass tax deductions on to investors. Additional provincial tax deductions may also be available depending on the province or territory in which the eligible expenses are incurred. For companies issuing flow-through shares, these tax deductions allow flow-through shares to be issued at a premium over the issue price for ordinary shares.

Disadvantages

The principal disadvantage of flow-through share investments is the inherent risk associated with mining and oil and gas exploration and development activities. Investors may reduce this risk by investing in flow-through share limited partnerships, which allow professional managers to build portfolios of flow-through shares and still allow the tax benefits to pass to the limited partnership investors.

For companies issuing flow-through shares, the principal disadvantage is that deductions renounced to investors are no longer available to offset the company’s taxable income. In the early stages of exploration and development, when potential revenue is distant, the premium available by issuing flow-through shares often outweighs the potential for increased tax. As companies mature, however, the premium available by issuing flow-through shares may cease to provide adequate compensation for the increased tax burden associated with renouncing available deductions to investors.



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Changes to the Canadian Prospectus and Registration Exemption Landscape: National Instrument 45-106

In order to maintain the integrity of, and foster confidence in, Canadian capital markets and to protect the investing public, Canadian securities laws require that a prospectus be filed and receipted by the appropriate regulatory authorities prior to the issuance or trade of a security (the “Prospectus Requirement”). A prospectus contains a high level of disclosure about the issuer of the securities, which allows the investing public to make a fully informed decision about potential investment opportunities. Similarly, no person may trade in a security unless they are registered with the appropriate regulator (the “Registration Requirement”). This requirement allows the appropriate regulatory authority to control industry participants and to restrict their entry into the financial markets unless they have fulfilled certain educational and other requirements.

National Instrument 45-106: Prospectus and Registration Exemptions

Exemptions have been created from each of the Prospectus and Registration Requirements in order to achieve certain policy objectives. Available exemptions can be grouped under the following four categories:

- (i) issuances of securities to persons who are familiar with the issuer through a special relationship that they have with the issuer (or as a result of separate disclosure that the issuer has provided in an information circular or other disclosure document) such that they do not need the protections offered by the Prospectus and Registration Requirements;
- (ii) the nature of the security itself is so safe that the investing public does not need to be protected;
- (iii) regardless of any particular connection to the issuer, the investor is sufficiently sophisticated and wealthy to make investment decisions without the benefit of protections offered by the Prospectus and Registration Requirements; and
- (iv) the issuer of the security is an institution which is regu-

lated by other comparable legislation such that the protections offered by the Prospectus and Registration Requirements are not necessary.

Historically, these exemptions have been scattered throughout securities legislation and they have differed between various Canadian jurisdictions. The purpose of this article is to discuss the recent developments in harmonizing the exemptions to the Prospectus and Registration Requirements across Canada, to highlight some of the most useful exemptions for those companies seeking to raise capital or entering into certain business transactions and to discuss the related filings and fees associated with using these exemptions.

On September 14, 2005, National Instrument 45-106 (the “Instrument”) came into force. The intent of the Instrument is to group all of the prospectus and registration exemptions applicable in all of the Canadian jurisdictions in one place. This is important for issuers who are issuing shares in multiple Canadian jurisdictions since it harmonizes the exemptions and their consistent availability across the country.

With the introduction of the Instrument, the availability of the registration and prospectus exemptions contained in the *Securities Act* (Ontario) have been removed (although the text

of these exemptions still appear in such Act.)

Frequently Relied-Upon Exemptions

What follows is a description of some of the most frequently relied-upon exemptions:

Private Issuer – A company that has restrictions on the transfer of its securities in its constating documents or security holders’ agreement and whose securities are beneficially owned by not more than fifty persons will qualify for an exemption from the Prospectus and Registration Requirements if the securities are issued to a person who is purchasing as principal and who falls into one of the eleven enumerated categories in subsection 2.4(2) of the

On September 14, 2005, National Instrument 45-106 came into force. The intent of the Instrument is to group all of the prospectus and registration exemptions applicable in all of the Canadian jurisdictions in one place.

Instrument, which categories include directors, officers, employees and those who are related to such persons, existing security holders and persons who are not the public.

Minimum Investment – There is an exemption from the Prospectus and Registration Requirements if the purchaser of the securities is purchasing as principal and the securities have an acquisition cost to the purchaser of not less than \$150,000 paid in cash at the time of the trade.

Accredited Investors – There are numerous components of the definition of “accredited investor,” which can generally be categorized as those institutions or governmental bodies that do not need the protections offered by the Prospectus and Registration Requirements or those individuals who have sufficient monetary resources to make their own informed investment decisions. There is an exemption from the Prospectus and Registration Requirements if there is a trade in a security to a purchaser who purchases as principal and who is an accredited investor. To satisfy itself that the purchaser is an accredited investor and that the exemption from the Prospectus and Registration Requirements is available, the issuer should obtain a certification from the Purchaser indicating the exact definition of accredited investor that they meet.

For private companies, fees are payable in each jurisdiction in which there was a trade and are generally based on the quantum of securities that were distributed in such jurisdiction.

Take-Over Bid – In the purchase of a business by way of the acquisition of shares, there is a trade of those shares and it is necessary to comply with the Prospectus and Registration Requirements or to determine the applicable exemptions from the Prospectus and Registration Requirements. If the purchase is for more than 20% of the shares of a particular class then it constitutes a take-over bid under applicable securities laws and there would be an exemption from the Prospectus and Registration Requirements under the Instrument.

Filings and Fees

Reliance on certain of the exemptions to the Prospectus and Registration Requirements necessitates a filing with the securities authorities in each of the jurisdictions in which trades took place and payment of the applicable fees.

Except in British Columbia, the filing is on Form 45-106FI, which is due within 10 days of the date of the trade. For private companies, fees are payable in each jurisdiction in which there was a trade and are generally based on the quantum of securities that were distributed in such jurisdiction.



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Tax Pitfalls of Granting Rights to Acquire Shares

Status as a Canadian-controlled private corporation (“CCPC”) can be inadvertently lost in fairly common circumstances. As a result, a corporation’s effective tax rate can be retroactively doubled and tax credits forfeited while, in some instances, shareholders can be denied access to the lifetime capital gains exemption. All of this results from an often overlooked interpretive rule.

The Rule

The rule in question is found in paragraph 251(5)(b) of the *Income Tax Act* (Canada) (the “Act”), which states that if a

person has a right to acquire shares in a corporation or to control the voting rights of such shares then that person will be deemed for certain purposes to be in the same position as if they owned those shares or controlled those voting rights now – unless the right was contingent upon the death, bankruptcy or permanent disability of an individual. This rule applies regardless of whether the right arises under a contract, in equity or otherwise, whether the right exists either immediately or in the future and whether it is absolute or contingent.

Consider how this rule would apply in the following circumstances.

A. An Agreement of Purchase and Sale

CanCo is a private company incorporated in Canada. The majority of its directors have always resided in Canada and there is no question of its mind and management ever residing anywhere else. Similarly, the majority of its voting shares have always been held by Canadian residents and there is no question of CanCo ever having been controlled, whether directly or indirectly, by a public company. CanCo is, in short, a CCPC.

CanCo is about to be sold for a considerable profit. Its shareholders, consisting mainly of its founding management, acquired their shares for nominal cash consideration. The terms of the sale have been informally agreed upon. But, before CanCo's shareholders will allow the purchaser to conduct due diligence, they want a signed agreement in place. The purchaser also wants an agreement in place to "lock in" the price and prevent CanCo's shareholders from entertaining offers from other parties. So, CanCo's shareholders and the purchaser sign a conditional agreement of purchase and sale in advance of closing. In so doing, they fail to consider the effect upon CanCo's CCPC status.

By executing the agreement of purchase and sale, even conditionally, the vendors will have granted the purchaser the right to acquire shares of CanCo for the purposes of paragraph 251(5)(b). The purchaser will therefore be deemed for certain purposes to have acquired not merely the right to acquire the shares but to have acquired the shares themselves. If, therefore, the purchaser is a public company, is not resident in Canada or is directly or indirectly controlled by a public company or a non-resident of Canada then CanCo will have lost its status as a CCPC. Had CCPC status been lost upon closing, there would be no problem since the change of control would result in a deemed year end, thereby limiting the tax consequences of the loss of status to the period following the sale. However, because CCPC status is lost before closing, there is no corresponding deemed year end such that the loss of status will affect the taxation of income for the entire current taxation year.

Effect Upon the Small Business Deduction and Lower Ontario Tax Rate

If CanCo loses its CCPC status prior to closing then it will lose the small business deduction and lower Ontario income tax rate available to CCPCs retroactively to the beginning of

the current taxation year. CanCo's effective tax rate on its first \$300,000 of taxable income for the taxation year preceding the sale will be thereby doubled.

Effect Upon SRED Credits

It may be that CanCo has earned substantial enhanced and refundable scientific research and experimental development ("SRED") credits in the current year or has carried them forward from past years. By losing CCPC status, it will lose the ability to apply all but the basic SRED credits in the taxation year preceding the sale.

Effect Upon an Option Holder

There would be no effect upon an option holder. Any person who acquired an option in CanCo while it was a CCPC would continue to enjoy the deferral of a taxable benefit pursuant to subsection 7(1.1) of the Act until such time as the subject shares are sold.

Effect Upon the Lifetime Capital Gains Exemption

There would be no effect upon the lifetime capital gains exemption. By operation of paragraph 110.6(14)(b) of the Act, entering into an agreement of purchase and sale will not affect CCPC status for the purpose of determining the availability of the lifetime capital gains exemption.

If a person has a right to acquire shares ... then that person will be deemed for certain purposes to be in the same position as if they owned those shares.

Solutions

The most common means of addressing the problem posed by paragraph 251(5)(b) is simply to wait until closing to sign the agreement of purchase and sale. Alternatively, the agreement of purchase and sale could be structured as a "put" with no corollary "call." In other words, the signed agreement could give the vendors the right to sell CanCo but would not give the purchaser any corresponding right to buy CanCo.

A more palatable option for the purchaser would be to address CanCo's reluctance to permit due diligence by relying upon a confidentiality agreement. Unfortunately, this solution would be less than satisfactory for CanCo if the purchaser were a competitor. Similarly, the purchaser's concern that the vendors not entertain other offers could be addressed by relying upon some form of exclusivity agreement. This would not, however, prevent the vendors from increasing the purchase price.

The final alternative is to create a new taxation year end by amalgamating CanCo with another entity prior to the sale. This would create a deemed year end and thereby limit the effect of paragraph 251(5)(b) to the period following amalgamation. Unfortunately, the Canada Revenue Agency has publicly stated that it would apply the general anti-avoidance rule in this circumstance. This approach could only succeed, therefore, if there were another corporation already in existence and there were an arguable business purpose served by the amalgamation.

B. Issuance of an Option

The discussion thus far has been limited to the grant of rights under an agreement of purchase and sale. However, the rule in paragraph 251(5)(b) is of broader application, contemplating any right to acquire shares in a corporation.

Consider now a situation in which CanCo's shareholders are contemplating a sale and have wisely decided to wait until closing to sign the agreement of purchase and sale. The vendors have been told by their professional advisors that their shares satisfy the definition of "qualified small business corporation shares" such that each shareholder will receive his sale proceeds tax-free in reliance upon the \$500,000 lifetime capital gains exemption. Being a prudent individual, the principal shareholder had even gone so far as to engage in some tax planning years before to ensure that a portion of the capital gain would be allocated to his spouse, thereby doubling the available exemption. Unfortunately, no one has considered the effect of an option to acquire shares granted to a non-resident.

Businesses Have to Buckle Up!

Remember the history of seatbelts? First it was a voluntary campaign to promote the fact that seatbelts save lives. Then the courts would find passengers partly responsible for their own injuries if they did not wear seatbelts. Finally, the legislature made seatbelts mandatory. The same thing is happening with corporate management. At first, auditors would only recommend better internal control mechanisms for management. Now, a court has held a corporation partly responsible for being defrauded because of a lack of internal controls. Soon, with *Sarbanes-Oxley* legislation flooding across our borders, we can anticipate internal control rules to become a mandatory part of corporate management practices.

Simply put, internal controls are the tools used every day by managers to help the organization achieve its objectives, and

Paragraph 110.6(14)(b) of the Act, which provides that paragraph 251(5)(b) does not apply for the purpose of determining the availability of the lifetime capital gains exemption, only applies in the context of an agreement of purchase and sale. This saving provision does not apply to the grant of an option. If, therefore, non-residents, public companies, persons directly or indirectly controlled by non-residents or public companies, or a combination of any of the foregoing, would control more than 50% of CanCo's voting shares upon the exercise of their options then CanCo would again lose its CCPC status. And, in addition to all of the consequences described in Part A, above, CanCo's shareholders would be denied access to the lifetime capital gains exemption.

Final Word

This article has addressed most but not all of the consequences of losing CCPC status. A professional tax advisor should be consulted before rights to private company shares are granted to non-residents, public companies or entities directly or indirectly controlled by such entities.



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include everything from written procedures to good business practices. Internal controls can be described as a system of appropriate checks and balances whereby if something is not as it should be, management is made aware of the situation so that they may take corrective action. It was traditionally believed that the extent of internal control that a business should establish was a judgement that must be made by management. Management's judgement regarding the extent of internal control necessary for the business was affected by the size of the organization, the number of personnel available and the risk and gravity of the loss or error. Internal controls are the mechanisms by which the corporation ensures the reliability of its financial and tax reporting and its compliance with applicable laws and regulations. Internal controls involve the segrega-

tion of duties between those who place orders, those who pay for them and those who account for them on the corporate books, as well as other supervisory mechanisms to ensure that material errors do not go unchecked within the company. Of course, one of the strongest internal controls in a small company was an imperious, autocratic owner who oversaw every aspect of the production, purchasing and sales processes personally. That is no longer acceptable.

In *Treaty Group v. Drake International Inc.* [2005] O.J. 5232, the plaintiff decided that the best way to protect itself against negligent and fraudulent employees was to hire the defendant employment agency to screen applicants for positions within the company. The business was originally a “Mom and Pop” leather jewelry manufacturing business that grew out of the basement of the home to be a \$1,000,000 business operating out of permanent business premises. The plaintiff’s business advisor recommended that they hire an office manager through the defendant, a global personnel and training company. The defendant failed to detect the prospective office manager’s previous criminal record and, therefore, she was hired by the plaintiff without any protective steps being taken. The office manager thereafter stole \$263,324.20, for which the plaintiff sued the defendant for

breach of contract, negligence and negligent misrepresentation. Despite acknowledging that the plaintiff was a “small rapidly growing family business,” the court went on to find that the plaintiff contributed to its own losses by (a) only requiring one signature on a cheque, (b) having the same person who prepared cheques perform the bank reconciliations, (c) failing to supervise the office manager in a meaningful way, (d) upper management failing to do bank reconciliations in a timely fashion and (e) upper management permitting blank cheques to be signed without proper follow up. The court therefore reduced the plaintiff’s recovery by half and awarded damages in the amount of \$131,662.10. In so doing, the court is signalling to small businesses that the days of the business judgement rule are fading in an era of rampant fraud and that it is time to do an internal audit of corporate processes before the legislature eventually mandates management to do so.



David Debenham is an associate in the Commercial Litigation Group in Ottawa. Contact him directly at 613-232-7171 ext. 103 or ddebenham@langmichener.ca. David is the author of the newly released text on the *The Law of Fraud and the Forensic Investigator*, published by Carswell Publications.

What’s New In Books?

The Law of Fraud and the Forensic Investigator (Carswell) by David Debenham

In this post-Enron age, executives and their counsel have to be prepared to deal with discoveries of management or employee fraud on a moment’s notice. In-house counsel have to gather and preserve evidence while retaining outside counsel and a forensic investigation team. Litigation counsel have to leap into action in order to preserve misappropriated evidence and assets. Both counsel have to quickly and seamlessly form a team of forensic investigators from a variety of other professions. Up to now, there were only texts which dealt with particular aspects of a fraud investigation from one or the other profession’s point of view. Now, with *The Law of Fraud and the Forensic Investigator*, litigation and in-house counsel alike have a cross-disciplinary reference book which contains a one-stop resource for the entire process from discovery to recovery.

The author, David Debenham, is both a lawyer and forensic accountant practising in the Ottawa office of Lang Michener, and so has written a book that provides insights into the roles of both professions in the fraud investigation. For in-house coun-

sel, the book provides a precedent engagement letter to begin retaining a forensic investigation team immediately and then provides step-by-step guidance on how in-house counsel direct that team in tandem with litigation counsel. For litigators, the book is replete with all the court precedents you will need, together with complete explanations of the law of fraud, the associated pre- and post-trial remedies and all the rules of evidence and procedure necessary to successfully guide the forensic experts through the judicial process.

The Law of Fraud and the Forensic Investigator provides a common playbook for all of the participants in the fraud investigation. Those who read this book, lawyer and investigator alike, are given a powerful and important tool to understand their role and the role of the other key players in a complicated and confused atmosphere that requires real-time decision-making in a pressure packed environment. David Debenham can be reached at 613-232-7171 ext. 103 or ddebenham@langmichener.ca.

To order a copy of the book, please contact Carswell at carswell.com.

Announcements and Speaking Engagements

We are pleased to announce that Leslie A. Vandor Q.C. has joined the Corporate Commercial Group as counsel in the Ottawa office



Mr. Vandor has a wide-ranging practice that encompasses corporate and commercial matters, litigation and media law. He is a prolific author of books and articles on legal topics and his monthly CBC Radio One and CTV call-in shows, on which he answers legal questions from listeners, has a substantial audience throughout Ontario.

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Lexpert's Leading 500 Lawyers in Canada

Lang Michener is pleased to announce that **Donald MacOdrum**, Chair of the Intellectual Property Group in Toronto, **C. J. Michael Flavell, Q.C.**, Chair of the International Trade Group in Ottawa, and **George C. Stevens, Q.C.**, Associate Counsel of the Mining Group in Vancouver, have been selected as part of *LEXPERT's* leading 500 lawyers in Canada.



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International Trade



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Speaking Engagements

Mergers and Acquisitions in the SME Market: Business and Legal Concerns

2006 Canadian Information Exchange: Mergers and Acquisitions Summit

May 15–17, 2006, Marriott Eaton Centre Hotel, Toronto

Laurence Goldberg, speaker

for more information, go to www.informationexchange.ca

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