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WIND ENERGY FINANCE
PRIVATE EQUITY

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INTRODUCTION

In recent months, private equity markets in both the US and Canada have seen a tangible slow down. In Canada alone, a total of $426 million in venture capital was invested during the second quarter of 2007, representing a decline of approximately 30% from the $606 million invested in the first quarter of 2007, and a decline of approximately 12% from the second quarter of 2006. (Canada’s Venture Capital & Private Equity Association).

That said, even now, a strong company with good business fundamentals and a viable business concept will be able to find private equity capital.

Ventures seeking capital in current private equity markets should begin planning for investment from day one. In wind power development, more than many other industries, prospective investment targets would be well-advised to “start with the end in mind”.

WHAT IS PRIVATE EQUITY?

“Private equity” is a term which tends to be used by investment industry participants as a catch-all for equity and subordinated debt investments in non-publicly traded companies. For lawyers (and other individuals obsessed with regulatory compliance) the term has a specific meaning: it refers to securities issuances which occur -legally- without the issuance or filing of a prospectus.

A “prospectus” is simply the fact-laden document which security issuers are legally required to distribute to prospective investors in order to adequately describe securities being offered for sale. A “security” can be a debt or an equity instrument of almost any kind and the “sale” of a security is so broadly defined as to capture almost any process by which any type of security is alienated. The various securities statutes and regulations in place across Canada dictate what information a prospectus must contain, and how and when it must be filed with regulators. There are serious criminal sanctions for falsifying prospectus information.

As a general rule, each of Canada’s 13 securities regulators restricts the sale or resale of any type of security unless a prospectus has been filed. This universal restriction is in place to protect the public from sharp business practices and has been in place in most North American jurisdictions since at least the 1930’s.

Preparing and filing a securities prospectus is both time-consuming and cost-prohibitive for most businesses. As a result, over the years a number of “prospectus exemptions” have been developed by securities regulators to permit certain securities issuers to sell securities to certain members of the public under specific circumstances without the need to prepare and file a full prospectus.

Private placements are simply prospectus-exempt securities issuances.
In Canada, private placements are exempted from the universal prospectus filing requirements in accordance with the provisions of National Instrument 45-106 — Prospectus and Registration Exemptions (NI 45-106). Coming into effect in September of 2005, NI 45-106 was an attempt by the Canadian Securities Administrators to harmonize the prospectus and registration exemptions contained in various provincial securities statutes. Unfortunately, the attempt at harmonization—though laudable—was not completely successful. As a result, there are slightly different private placement rules still in existence across the country.

Canada’s prospectus exemptions can be classified into the following categories: (a) capital raising exemptions, (b) transaction exemptions, (c) employee, director and consultant exemptions, and (d) miscellaneous exemptions. The rules relating to each of these exemptions are complex and, depending on the specific exemption being relied upon, may require the securities issuer to obtain specific factual representations from prospective investors, to distribute specific informational items to such prospective investors and to make pre and/or post-closing filings with one or more securities regulators.

WHAT ARE PRIVATE EQUITY INVESTORS LOOKING FOR?

Private equity underwriters will often tell potential clients that they look at the following characteristics before accepting a mandate to raise capital:

1. **The Management Team** – As the old investment industry saying goes: “Bet the jockey, not the horse”. Equity investors will take a very hard look at who the management team of the prospective investment target is. Industry experience, strong technical skills, industry contacts and a depth of business experience are all elements that private equity investors will want to consider. Recruiting a management team and a board of directors that brings these talents and characteristics to the table early on makes the underwriter’s role significantly easier.

2. **The Business Concept** – Private equity investors investing in start-up ventures will want to know that they are investing in a company which stands a good chance of succeeding. They are looking for superior return on investment and will want to hear a compelling business story—a unique business opportunity, well-understood barriers to entry, the prospect of becoming a dominant player in a nascent high growth industry, etc.

3. **The Liquidity Horizon** – Although it is rare for the management team of a start-up venture to know from the outset what future liquidity prospects will be, venture investors will want to know that future liquidity prospects have been considered: that there has been some interest shown by potential up-stream purchasers, or, that the business model shows cash flow growth so substantial as to make a public securities offering and/or investment payback in the form of dividends realistic within a reasonable time horizon (3-5 years).
PLANNING FOR PRIVATE EQUITY INVESTMENT

The key to attracting investment capital down the road is to start building an attractive
environment for investment now: Start with the end in mind.

Nowhere is this more true than in wind energy, where the exploration and development phases are followed quickly by large scale capital needs and where each stage of project development is heavily dependant upon the foundations laid at an earlier stage. In order to stand a reasonable chance of gaining access to private capital markets, wind energy entrepreneurs need to consider the following items early on in the development of their business:

(a) **Having a Compelling Business Plan** – The underwriter or securities advisor acting for the venture will normally review this document in order to determine whether or not the proposed investment is (i) viable and (ii) marketable to investors. Although most underwriters will say that this document is relatively unimportant in their assessment of a prospective investment target, having a clear and compelling Business Plan is often a prerequisite to winning an initial meeting with an underwriter. This document should not be widely distributed, unless approved by legal counsel, as it may be considered an “offering memorandum” and thus subject to additional regulatory filing and content requirements;

(b) **Having Access to Experienced Counsel** – Securities issuances are highly regulated and can be fertile ground for litigation. The laws effecting private placements also change frequently and are also regularly interpreted by the courts. Having access to knowledgeable legal counsel experienced in private equity placement can make a significant difference in both the efficiency of the transaction and in the minimization of risk for the issuer, the issuer’s management team and early investors;

(c) **Having a Basic Financial Package** – The underwriter and the prospective investors will want to see the most recent financial statements of the company, including a Balance Sheet and an Income Statement. Depending on the size of the offering, these financial statements do not necessarily need to be audited statements. In addition, cash-flow projections and/or a burn-rate models showing where the capital raised will go and how money is expected to flow into and out of the company will help the underwriter determine whether or not the investment meets its underwriting standards;

(d) **Having the Right Team** – Assembling the right management team and the right Board of Directors early will have a significant impact on whether or not the venture is a success. Underwriters will want to review executive biographies, compensation packages, non-competition covenants, option plans and share ownership structures in order to be assured that the right individuals are dedicated to the venture, reasonably well compensated and ‘incentivized’ to stay involved in the business over the longer term;

(e) **Having High Quality Business Agreements in Place** – In wind energy development, key documents such as real estate option, easement or leasing agreements, and the early stage employment, consulting, engineering, procurement and construction agreements can be critical in determining whether or not the project is financially viable. In addition, although these agreements are usually negotiated later in the development process, Power Purchase Agreements, Turbine Purchase Agreements and joint venture arrangements may also form a critical part of the
business package being sold to investors. Underwriters, and underwriters’ counsel, will review these documents in detail as part of their due diligence process, so ensuring that these early and mid-stage business agreements adequately protect the interests of the potential investment target (i.e. the business) is a key step toward preparing for private equity financing stages.

(f) Having Corporate Records in Order – In wind energy, as in most start up ventures, not a great deal of thought is given to the capital structure of the business during the early phases of development. Founders may have incorporated the operating company on their own with outdated, overly restrictive or completely irrelevant share provisions. A shell company from a previous venture may have been used without adequate thought having been given to the potential liabilities attached to it or the tax consequences arising from its use. Verbal and/or loosely written understandings between the company and early-stage family/friend investors may have been reached and may have yet to be adequately reflected in the minute book and financial statements. A company seeking to become the beneficiary of private equity investment should have its corporate records in order, with proper recording of annual general meetings, up-to-date public filings, up-to-date records of previous share issuances and loans made and a complete record of any existing shareholders agreements, employee share ownership plans, trust arrangements and the like. If there are any concerns with the corporate records of the company, these should be addressed prior to initiating discussions with a prospective underwriter.

Canada’s investment banking community is small and somewhat cohesive. Securities underwriters often share company observations with other underwriters and, if a deal looks attractive, will often want to syndicate private equity placements among a number of different firms. Reputation is crucial. Accordingly, it is important that entrepreneurs have a tightly-written and clearly conceived business case and a well-run business to present before they even begin speaking with prospective investors or underwriters.

THE BASIC DOCUMENTS OF A PRIVATE PLACEMENT TRANSACTION

Depending on the nature of the transaction, the jurisdiction in which the securities are sold, the types of securities being offered for sale and the relative sophistication of the parties, the documents negotiated and prepared by the parties to the transaction can be quite substantial. The main documents which issuers, underwriters and prospective purchasers will focus on at various stages in the transaction are as follow:

The Engagement Letter

The Engagement Letter sets out the basic deal structure between the issuer and the underwriter. It contains basic business terms, such as the underwriter’s commission, the pricing of the issue, the size of the issue, the anticipated timing of the closing, the level of commitment by the underwriter (i.e. “best efforts” or “bought deal”). The Term Sheet (in draft or final form) is often attached as a schedule to the Engagement Letter. The Engagement Letter is normally executed within the first few days after the underwriter has been retained and is then normally supplanted by the more formal and detailed Underwriting Agreement.
**The Term Sheet**

The Term Sheet sets forth the basic structure of the offering: the proper name of the issuer, the proper name of the underwriter, the pricing of the securities being issued, the basic attributes of the securities being issued, the size of the offering, the nature and amount of compensation being paid to the underwriter(s), the jurisdiction where the securities are being sold, etc. There is a tendency among securities issuers to want to put details and, occasionally, “selling points” regarding the target company into the Term Sheet. For regulatory reasons, this tendency should be avoided and the Term Sheet should be no longer than 1-2 pages and contain only factual statements about the characteristics of the offering.

**The Underwriting Agreement**

The Underwriting Agreement is the agreement which formally delineates the relationship between the underwriter and the issuer. It contains the basic information governing the proposed issuance - the pricing, the basic attributes, the offering size, etc.- and it also contains terms specifically defining the respective liabilities, warranties, representations and responsibilities of the parties, the level of commitment made by the underwriter, the time period which the underwriter has to complete the transaction, the underwriter’s compensation, the underwriter’s ability to recoup expenses (including its legal fees and travel costs), and, often, a right of first refusal giving the underwriter a reasonable opportunity to act for the issuer on future financing transactions. Though negotiated beforehand, the Underwriting Agreement is normally executed at the closing.

**The Subscription Agreement**

The Subscription Agreement is the basic document signed between the issuer and the security purchasers. It is normally negotiated between the underwriter and the issuer, though, occasionally, parties purchasing a significant portion of the securities being offered may seek to dictate terms. The Subscription Agreement contains the representations and warranties being made by the issuer, as well as the representations and warranties being made by the purchaser –including specific representations and warranties required of the purchaser as to residency or their qualification as an accredited investor. It also contains the purchaser’s specific instructions as to registration. The Term Sheet and the certificate establishing the investor as an accredited investor under NI 45-106 accrediting will normally be attached to the Subscription Agreement. Often, the ability of the underwriter to obtain properly completed and executed Subscription Agreements from all of the investors who have expressed interest in the offering will be a key factor in determining whether or not the placement will close on time. Closing delays arising as a result of missing or incomplete Subscription Agreements are quite normal and should be accommodated when planning the security offering.

**THE TIMELINE OF A PRIVATE PLACEMENT**

Unlike public offerings which can take several months to complete, prospectus exempt offerings can occur relatively quickly. The following table sets out an approximate time line for an underwritten private offering:
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<th>Weeks</th>
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| 1–3   | - Review and, if necessary, make changes to corporate capital structure, management structure, board structures, management compensation structures and contractual commitments  
       - Interview and select underwriter(s) |
| 3     | - Work with underwriters to develop marketing strategy, begin road shows  
       - Underwriter’s Engagement Letter signed  
       - Term Sheet drafted |
| 3–4   | - Underwriter’s counsel to establish appropriate due diligence strategy  
       - Issuer’s counsel to prepare a draft Subscription Agreement  
       - Term Sheet finalized |
| 3–5   | - Road shows continue  
       - Detailed Agency Agreement executed  
       - Signed Subscription Agreements obtained by Underwriter |
| 5–6   | - Legal documents finalized for pre-closing  
       - Finalize legal opinions to be provided by Issuer’s counsel |
| 6     | - Closing |
| 6–7   | - Post-closing regulatory filings |

**A WORD ABOUT FLOW-THROUGH SHARES**

Flow-through shares - which would have been unfamiliar to most entrepreneurs operating outside of the resource sector a few years ago- are now a wind industry standard. In Canada, these tax-sheltered investment vehicles have traditionally been available to mining and petroleum companies, having been designed to facilitate early exploration and project development financing. However, in recent years, this tax-effective investment vehicle has been made available to qualifying renewable energy projects.

Like normal common or preferred shares, flow-through shares permit equity investors to receive an equity interest in the company. However, the benefit of flow-through shares is that they permit the income tax deductions associated with expenditures incurred by the company on exploration and development to be passed through to equity investors.

In a simple flow-through share structure, investors would acquire shares of the company (either directly or indirectly through a limited partnership) and, under the terms of the investment (normally set forth in the Subscription Agreement) the company would agree, for purposes of the *Income Tax Act*, to “renounce” (or “pass-along”) what are called Canadian renewable and conservation expenses or “CRCE’s” to the shareholders. The passing of CRCE’s effectively reduces the investor's investment amount (commonly by more than a third) and thus reduces the net cost of the investment to the investor. This can be a very significant advantage to junior wind energy companies which pay little or no tax during their start-up phase, are often unable to use income tax deductions against their corporate income and are willing to forgo the deduction to new investors. As a result, many securities issuances by wind power developers operating in Canada are done as flow-through share issuances.

*The attachments have been removed from this document as they need to updated regularly.  
Please contact the author for further information.*