

Mergers and Acquisitions Involving Canadian REITs



The period from 2010 through 2014 was a very active one in the Canadian REIT sector. During this time, 30 new REITs completed their initial public offerings and/or listed on a Canadian stock exchange, and a number of Canadian REITs merged with other REITs or were taken private. For 2015, with expectations that interest rates in Canada may stay low for an extended period, some analysts and other market participants expect higher levels of activity in the REIT sector and believe that opportunities for strategic acquisitions or mergers involving Canadian REITs may increase. In addition, with the decline in the Canadian dollar over the past year, U.S. and foreign acquirors may look to Canada for merger and acquisition opportunities involving Canadian REITs.

Goodmans is widely recognized as one of Canada's leading transaction focused law firms, with particular depth and expertise in REITs. The summary below discusses some of the unique features of Canadian REITs that should be considered in an M&A transaction and provides an overview of two common structures used to implement Canadian REIT mergers.

Overview of the Canadian REIT Market

Canada has a robust REIT market with over 50 publicly traded real estate investment trusts ("REITs") with an aggregate market capitalization in excess of C\$60 billion. Many REITs specialize in specific industries - including residential, retail, office, industrial, healthcare and hospitality - while others hold diversified portfolios of properties spanning several industries. Some REITs own properties only in Canada, while others own, in addition or exclusively, portfolios in the United States or other countries.

Unique Aspects of Canadian REITs

The Declaration of Trust

REITs in Canada are structured as trusts and, unlike corporations, there is no general statute governing REITs. Each Canadian REIT is instead governed by a declaration of trust, overseen by a board of trustees and subject to the principles of common law and trust law. A declaration of trust will contain provisions that are similar to those in Canadian corporate statutes and, among other things, establishes the duties of trustees (which is to act honestly, in good faith and in the best interests of the REIT, and to exercise the degree of care, diligence and skill that a

reasonably prudent person would exercise in comparable circumstances). A REIT's declaration of trust will also contain provisions governing the REIT's formation, the election, appointment and removal of trustees, dealing with conflicts of interest, establishing the process for calling and holding unitholder meetings and the process for amending the declaration of trust. Although declarations of trust tend to be fairly consistent from REIT to REIT, each declaration of trust has unique features and must be carefully reviewed in planning an M&A transaction.

External Management and other Arrangements

A number of Canadian REITs are externally managed and do not have their own employees. For these REITs, an external management company performs the REIT's key management functions, typically providing strategic, asset management, administrative and other services. In these situations, the terms of the management agreement between the REIT and the external manager can be an important consideration in structuring an M&A transaction. Any acquiror of the REIT will have to be prepared to either assume those functions (if the management agreement is to terminate) or make arrangements with the manager to continue in some capacity after the transaction closes. Some external management agreements provide for termination rights upon a change of control of the REIT and include provisions requiring payment of a fee to the manager if the agreement is terminated.

In addition to external management agreements, some REITs have ongoing arrangements with their sponsors that may include development agreements, head lease agreements, property management agreements, rights of first offer or refusal or governance rights (such as board appointment or nomination rights or approval rights for fundamental transactions). The impact of these agreements and rights will have to be considered in planning for an M&A transaction.

Exchangeable Securities

Many Canadian REITs have issued exchangeable securities of a subsidiary entity (typically a limited partnership) to their sponsors or third parties. These structures are implemented to permit properties to be sold to a REIT on a tax deferred basis. Exchangeable securities are designed to be the economic equivalents of REIT units, receiving distributions equivalent to distributions made to holders of REIT units and exchangeable at the holder's option into REIT units. Exchangeable securities are often issued with special voting units of the REIT, providing a holder with voting rights on REIT matters. Exchangeable securities may also have rights that are triggered by a change of control transaction, including drag-along and tag-along rights or pre-emptive rights that will need to be considered in an M&A transaction.

Convertible Debentures

Many Canadian REITs have issued publicly-listed debentures that pay a fixed rate of interest over their term and are convertible at the holder's option into REIT units at a price per unit that is fixed at the time the debentures are issued. Convertible debentures are typically unsecured instruments with limited restrictive covenants (normally without financial covenants) and have terms of five to seven years. Convertible debentures may contain provisions allowing a successor entity of the REIT to assume the REIT's obligations under the debentures and provide the debenture holder with a "put right" on a change of control of the REIT. The "put right" entitles the holder to require the REIT to purchase the debentures at par or, in some cases, a slight premium to par. As this "put right" may be triggered in an M&A transaction, an acquiror may need to account for the possible payout of any outstanding debentures in planning for a transaction. In cases where an exchange of securities is contemplated, the successor issuer provisions of the debentures, may allow the acquiror to assume any debentures, with the

debentures becoming convertible into securities of the acquiror after the transaction closes. In all-cash transactions, debentures may be defeased by the acquiror or the acquiror may seek to amend the debenture terms to redeem them at or following closing of the transaction.

Canadian REIT M&A Structures

Unlike in the United States, there is no federal securities commission in Canada. Securities activities are regulated at the provincial level and each of Canada's ten provinces has its own securities regulator. Despite this provincial regulatory regime, for the most part the laws relating to public mergers and acquisitions are harmonized across Canada.

Two common transaction structures that are used to complete a merger or acquisition involving a Canadian REIT are a plan of arrangement and a take-over bid¹. Set out below is an overview of these two transaction structures.

Plans of Arrangement

In Canada, take-overs or mergers of public entities can be completed under a process known as a plan of arrangement. A plan of arrangement is a "one-step" transaction governed by Canadian corporate statutes that, if desired, will result in the purchaser acquiring 100% of an entity. A plan of arrangement is a court-supervised process requiring approval of a Canadian court and the target's shareholders (typically by two-thirds of the shares voted at a shareholders' meeting). Once approved by the court and the shareholders, a plan of arrangement binds all securityholders of the company. Plans of arrangement are usually only conducted with the cooperation of the target entity's board on a friendly basis, given the target's significant involvement in obtaining the requisite approvals. Plans of arrangement can be completed within approximately 60 days following execution of an arrangement agreement for a transaction. If securities of the acquiror will be distributed to target securityholders in connection with a transaction, the court's approval of the transaction as being "fair and reasonable" is typically considered to constitute a "fairness hearing" for purposes of the 3(a)(10) exemption from the registration requirements under the *United States Securities Act of 1933*.

¹ In addition to these two transaction structures, some REIT M&A transactions have been structured as "acquisition and redemption" transactions, which involve the acquisition of the REIT's assets by the acquiror in exchange for cash and/or securities of the acquiror followed by the redemption of the units of the REIT for the acquisition consideration. In cases where the acquisition consideration consists of securities of another Canadian REIT, this structure has been used to provide a tax deferral to the target unitholders.

Although REITs are not governed by corporate statutes, Canadian courts have generally allowed REITs to utilize a plan of arrangement to effect a transaction and bind its securityholders where a corporation in the REIT's structure is affected by the transaction and falls within the relevant statute's regime. Because of the often complex structuring of REITs and the steps that are therefore required to efficiently complete an acquisition, plans of arrangement are effective tools for acquirors looking at a transaction in Canada.

In reviewing a plan of arrangement, the court must determine whether or not the arrangement is "fair and reasonable" to the target's various stakeholders and will hear submissions from any interested parties that are affected by the plan of arrangement. Although this process can create a forum for parties to raise objections to the transaction, once court approval is granted, it is less likely that a transaction can be successfully challenged by a third party.

As part of the securityholder approval required for a plan of arrangement, a management information circular of the target REIT containing prescribed information (including prospectus-level disclosure on the acquiror if the acquiror's securities form part of the consideration) must be prepared and delivered to the REIT's unitholders and other affected stakeholders. No review of the information circular by a Canadian securities commission is required, whether or not the consideration offered under the plan of arrangement is cash or securities. In addition to approval by not less than two-thirds of the units voted at a meeting of the target's unitholders, approval of the transaction by a majority of the votes cast by "disinterested" minority unitholders of the target may be required where the transaction includes arrangements with "related parties" of the target.

Take-Over Bids

In Canada, as in the U.S., take-over bids (tender offers) can be used by potential acquirors to acquire a public issuer on a hostile² or friendly basis. A take-over bid involves the preparation and delivery to the target REIT's unitholders of both a take-over bid circular and a trustees' circular (responding to the take-over bid). The take-over bid circular and trustees' circular must contain certain prescribed information (including prospectus-level disclosure on the acquiror if the acquiror's securities form part of the consideration). Unlike in the U.S., no securities commission review of the take-over bid circular is required, regardless of the form of consideration offered under the take-over bid. A take-over bid must, among other things, be made to all of the target REIT's unitholders, stay open for acceptance for at least 35 days from the date the take-over bid is launched, offer identical consideration (i.e., no collateral agreements, subject to certain exceptions) or an identical choice of consideration to all holders of the same class of securities and not be conditional upon the bidder obtaining financing³.

Under a take-over bid, if an acquiror wishes to acquire 100% of a target issuer, a two-step process is normally required to complete the transaction. The first step is the launch and take-up of securities under the take-over bid; the second step is either a compulsory acquisition (which can generally be pursued if more than 90% of the outstanding REIT units, other than units held by the acquiror or an affiliate or associate of the acquiror at the date of the take-over bid, are acquired under the bid) or a "squeeze-out" transaction (which can be pursued if more than two-thirds of the target's outstanding securities are acquired under the bid). As the compulsory acquisition provisions for Canadian REITs are set out in their declarations of trust and can vary from REIT to REIT, it is important that they be carefully reviewed. A second stage "squeeze out" transaction typically involves amendments to a REIT's declaration of trust and therefore requires approval of the REIT's unitholders either at a meeting of unitholders or by written consent⁴.

² Although the general framework for regulating hostile bids is similar in Canada and the United States, there are several differences that make Canada a more 'bidder friendly' jurisdiction. For instance, unlike in the U.S., poison pills in Canada generally cannot be used to "just say no" to an unsolicited offer. In most cases, Canadian securities regulators will "cease trade" a poison pill (i.e., render it ineffective) once the offer has been outstanding for a sufficient amount of time to allow the target board to explore alternate transactions. For further information on hostile take-over bids in Canada see Goodmans summary dated September 22, 2014 "Hostile Take-Over Bids in Canada" available at http://www.goodmans.ca/Doc/Hostile_Take_Over_Bids_in_Canada.

³ Canadian securities regulators have recently proposed certain amendments to the take-over bid rules in Canada that would require that all non-exempt take-over bids: (i) be subject to a mandatory tender condition that a minimum of more than 50% of all outstanding target securities owned or held by persons other than the bidder and its joint actors be tendered and not withdrawn before the bidder can take up any securities under the bid; (ii) be extended by the bidder for an additional 10 days after the bidder achieves the mandatory minimum tender condition and the bidder announces its intention to immediately take up and pay for the securities deposited under the bid; and (iii) remain open for a minimum of 120 days, subject to the ability of the target board to waive, in a non-discriminatory manner when there are multiple bids, the minimum period to a period of no less than 35 days. It is unclear whether, or when, these amendments will be adopted.

⁴ Under Canadian corporate law, a second stage "squeeze out" normally cannot be conducted by written consent as 100% shareholder approval is required for a written resolution. However, for REITs, a written consent of two-thirds of the REIT's outstanding units may be sufficient to implement a second stage "squeeze out" transaction depending on the provisions of a REIT's declaration of trust. Exemptive relief from the Canadian securities commissions may be required for a "squeeze out" conducted by written consent.

Regulatory Approvals

An M&A transaction involving a Canadian REIT may be subject to review under the *Competition Act* (Canada) and the *Investment Canada Act*. The acquisition of an interest in a Canadian REIT that entitles the acquiror and its affiliates in combination to receive more than 35% of the profits of the REIT or more than 35% of the assets of the REIT on dissolution could trigger merger notification or review requirements under the *Competition Act* (Canada).

The acquisition of 33.3% or more of the voting securities of a REIT that carries on a business in Canada by a non-Canadian could trigger notification or review requirements under the *Investment Canada Act*. In addition, acquisitions that may implicate national security concerns are subject to more stringent rules, and acquisitions of REITs in specific industries, such as healthcare, may be subject to other government approvals. Regulatory timelines to receive any approvals required under these statutes must be taken into account in planning for a transaction.

About Goodmans

Goodmans is one of Canada's pre-eminent business law firms with market-leading expertise in M&A, corporate and transaction finance, private equity, real estate, REITs, tax, restructuring, litigation and other business-related specialities.

Goodmans is widely recognised as Canada's leading law firm for REIT and other real estate capital markets transactions. We acted on the first public offering of a REIT in Canada and have been counsel on a majority of the IPOs of Canadian REITs and a vast majority of the IPOs of cross-border REITs on the Toronto Stock Exchange (TSX).

We have played a key role on many M&A transactions involving REITs, including: Canada's first mutually initiated combination of REITs (RRR/CPL, 2002); the \$2.5 billion going-private and connected transactions involving HealthLease Properties REIT, Health Care REIT and Mainstreet Property Group (November, 2014); and the recently announced \$2 billion combination of Northwest Healthcare Properties and Northwest International to form the only global healthcare REIT on the TSX (March, 2015).

Goodmans was selected by the Real Property Association of Canada (REALpac) as exclusive author of REALpac's *Canadian REIT Handbook*.

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