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Update

Income Trusts Law

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Acquiring Canadian Income Trusts

On November 7, 2006, Canada's Parliament approved the Canadian government's plans to start taxing most publicly traded income trusts starting in 2011 (REITs will generally be exempt, as will income from a trust's U.S. or other foreign subsidiaries that do not carry on business in Canada). This will generally eliminate the favourable tax treatment of income trusts in Canada relative to corporations.[1]

The announcement had predictable capital market consequences – the Toronto Stock Exchange's income trust index lost 16.3% of its value in two days of trading. Some issuers were down significantly more than that. Although prices have rebounded somewhat since, analysts expect a permanent correction to income trust valuations. This may provide an opportunity for private equity and other buyers to acquire income trust issuers or their underlying businesses at attractive prices.

What is an Income Trust?

An income trust seeks to invest in assets that produce a stable or predictable stream of income. Historically, an income trust was able to distribute its pre-tax operating income to unitholders, reducing or eliminating corporate or asset-level tax. Like the stock of a public company, the units of the trust are publicly traded on a stock exchange and represent a beneficial interest in the issuer with a vote at meetings of unitholders.

Canadian income trusts were first developed in the mid-1980's and initially focused on owning oil and gas properties (royalty trusts) and real estate (REITs). Over the past several years, a wide variety of operating businesses have also been organized as income trusts. There are now approximately 250 income trusts listed in Canada with an aggregate market capitalization (prior to the announcement of the new tax) of about CDN$200 billion. These trusts own businesses in a wide variety of sectors, including industries as diverse as telephone directories, movie theatres, brewing and waste disposal.

Acquisition Structures

In some ways, acquiring a Canadian income trust is the same as acquiring a Canadian public company. Income trust units trade on stock exchanges in the same way that public company shares do and Canadian securities laws apply equally to all reporting issuers regardless of whether they are organized in income trust or corporate form. Take-over bids for income trusts are generally similar to take-over bids for corporations.

On the other hand, one of the most important differences between income trusts and public companies from an M&A perspective is that income trusts are not subject to corporate law. This can have important consequences for the way income trust acquisitions are structured. Since there is no overriding statutory framework, an income trust's declaration of trust – a document that governs how the trust will operate – must be examined closely to understand potential structuring opportunities and limitations.

Take-Over Bids

To acquire an income trust by take-over bid, an acquiror makes a public offer to purchase all of the outstanding units of the trust by mailing a take-over bid circular to all of the trust's unitholders. This may be done on a friendly basis (in which case there will often be a negotiated support agreement between the acquiror and the income trust that precedes the bid itself) or as an unsolicited bid.

Take-over bids are regulated by Canadian securities laws. Among other things, a take-over bid must:

- be open for acceptance for at least 35 calendar days;
- offer the same consideration to all unitholders; and
- not be subject to a financing condition.

To acquire any units not tendered to a bid, the acquiror must undertake a second-step transaction:

- if at least 90% of the outstanding units are tendered to a bid, most declarations of trust allow the acquiror

[1] For details of the proposed changes and their implications for income funds, see Goodmans Update: Canada to Tax Income Trusts and Publicly Traded Partnerships (November 8, 2006).

to complete an acquisition of the remaining units without further approval or action from the remaining unitholders – this mirrors the compulsory acquisition rights generally available to acquirors under corporate statutes; or

- if less than 90% of the outstanding units are tendered, the acquiror could attempt to squeeze out minority unitholders by amending the declaration of trust to allow for the redemption of their units.

Amending a declaration of trust to effect a second-step transaction requires unitholder approval. The specific approval threshold will be set out in the declaration of trust. Most declarations of trust require the approval of at least 66 2/3% of the outstanding units voted on the proposed amendment. Canadian securities laws also typically require that the amendment be approved at a unitholder meeting by a "majority of the minority". Units acquired under the bid can usually be counted toward the required minority approval.

Some declarations of trust provide that amendments may be approved by a written resolution signed by the holders of at least that number of units required to approve the amendment at a meeting. In these circumstances, subject to the receipt of certain regulatory approvals, a take-over bid for an income trust could provide that tendering to the offer is also approval of any declaration of trust amendments necessary to complete a second-step transaction. This mechanism is not available in public company take-over bids because a written shareholder resolution would have to be signed by all of the target's shareholders; it can significantly accelerate completion of a second-step transaction in a take-over bid for an income trust by avoiding the need for the acquiror to prepare a proxy/information circular and hold a unitholder meeting to obtain the necessary unitholder approvals.

Single-Step Transactions

Some buyers prefer single-step acquisition structures because acquiring less than 100% of the target entity (as is the case, at least initially, under a take-over bid) complicates financing arrangements and limits access to the target's balance sheet. The presence of a publicly traded minority interest can also restrict the acquiror's ability to operate the acquired business for its own benefit. In other cases, the acquiror may insist on a single-step transaction such as an asset sale for tax reasons.

A single-step acquisition of an income trust may be structured in a number of ways, including as:

- a recapitalization transaction pursuant to which all of the units of the income trust (other than units owned by the acquiror) would be redeemed; or
- a sale of all or substantially all of the trust's assets to the acquiror.

The structure selected is often driven largely by tax considerations. Single-step acquisitions require the target's cooperation and are generally implemented pursuant an acquisition agreement between the acquiror and the target.

An income trust's declaration of trust will typically require the approval of at least 66 2/3% of the outstanding units voted on the single-step acquisition. If the acquiror has a pre-existing ownership position in the target trust, "majority of the minority" approval would also be required. These approvals would be obtained at a unitholder meeting called to consider the transaction. A detailed proxy/information circular describing the transaction would be prepared and delivered to unitholders in advance of obtaining the approval. Unlike shareholders, unitholders who object to such a transaction generally do not have dissent or appraisal rights or access to an "oppression" remedy.

Other Considerations

Tax Consequences

The tax consequences of a transaction structure – to the acquiror, the unitholders and the underlying business itself – will often be a determining factor in structuring an income trust acquisition. For example, in certain circumstances, the tax consequences to unitholders of a take-over may be more favourable than a single-step transactions. Conversely, single-step transactions may provide an opportunity for the acquiror to "step-up" the tax basis of the acquired business in a manner that is not available if the units of the fund are acquired. Tax planning opportunities and issues associated with an income trust acquisition are often complex and should be dealt with early in the planning stages of any transaction.

Retained Interests

In many cases, the initial sponsors of an income trust and subsequent vendors of assets to the income trust retain an interest in the business owned by the trust. This interest is usually represented by securities of an operating subsidiary that are convertible into units of the trust. Retained interest holders may have special approval rights or veto powers that could prevent an acquisition from proceeding without their consent, giving them significant leverage. It may also be impossible for an acquiror to force retained interest holders out of the income trust structure in connection with an acquisition of the trust. As a result, the presence of a retained interest may significantly complicate an income trust acquisition and should be carefully considered in structuring a transaction.

Trustee Duties and Defensive Tactics

In responding to an acquisition proposal, the trustees of an income trust are generally subject to similar fiduciary duties and responsibilities as the directors of a corporation would be in analogous circumstances. Among other things, this means that once they have decided to sell the trust, trustees must attempt to maximize unitholder value.

In exercising these duties, trustees can generally respond to an unsolicited offer by engaging in similar defensive tactics as would be available to the directors of a corporation. This may include implementing a unitholder rights plan (a "poison pill"). However, in Canada it is difficult for trustees to "just say no" to a hostile bid as Canadian securities regulators will generally require that unitholders ultimately be given an opportunity to accept or reject an offer. Accordingly, rights plans will not be permitted to remain in place indefinitely.

Regulatory Issues

An acquisition of a Canadian income trust will give rise to similar regulatory approval requirements as an acquisition of a Canadian company. These approvals might include pre-notification and/or clearance under the Competition Act (Canada) and, if the acquiror is a non-Canadian, the Investment Canada Act.

Toe-holds and Public Disclosure

Canadian securities laws generally allow accumulation of a toe-hold position in an income trust of up to 20% of the outstanding units of the trust. Any offer to acquire units that would result in the acquiror and any "joint actors" collectively owning 20% or more of the outstanding units will, subject to certain exceptions, require the acquiror to make a take-over bid to all unitholders.

No public disclosure of an ownership position in an income trust is required in Canada until the acquiror (together with any joint actors) owns 10% or more of the outstanding units. Once the acquiror crosses the 10% threshold, immediate public disclosure of the ownership position and investment intent is required. As long as the acquiror owns more than 10% of the outstanding units, ongoing public disclosure of all trades in units of the trust will be required. In addition, any acquisition of an income trust by a 10%+ unitholder or other "insider" will be subject to the going private transaction rules of Canadian securities regulators, which in some circumstances could require the acquiror to obtain an independent valuation of the trust and/or majority of the minority approval for the transaction. As a result, in many cases potential acquirors limit toe-hold positions to less than 10%.

About Goodmans LLP

Goodmans LLP is internationally recognized as one of Canada's premier transaction law firms. We have leading practices in mergers & acquisitions, income funds and REITs, corporate finance, private equity and tax and have extensive experience advising on Canadian income trust acquisition transactions.

Our most recent publicly announced retainers include representing Avion Group HF in its acquisition of Atlas Cold Storage Income Trust, Retirement Residences REIT in its acquisition by the Public Sector Pension Investment Board, the special committee of Summit Real Estate Investment Trust in the acquisition of Summit by ING Real Estate Canada Trust and the special committee of O&Y Real Estate Investment Trust in the acquisition of O&Y Properties Corp. and O&Y Real Estate Investment Trust by a consortium led by Brookfield Properties Corp.

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