

Securities and Mergers & Acquisitions Bulletin

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Fasken Martineau DuMoulin LLP

European Union-Canada Cross-Border Acquisitions Using Exchangeable Shares

For over a decade, U.S. corporations have been active acquirers of Canadian corporations using exchangeable shares issued by Canadian subsidiaries as consideration to facilitate their acquisitions. EU corporations should take note: the use of exchangeable shares is also available to EU corporations acquiring Canadian corporations. This article examines the advantage of using exchangeable shares, describes the basic structure of an exchangeable share transaction and addresses the principal corporate, tax and securities issues which arise in connection with the transaction.

existing shareholders of a target corporation with a tax-deferred rollover may be a significant disadvantage to a EU corporation that wants to acquire the Canadian target and pay for the acquisition by issuing its own shares. Therefore, the principal advantage of an exchangeable share transaction is to achieve tax-deferred rollover treatment for the existing shareholders of the Canadian target.

Additional Canadian tax advantages of using exchangeable shares include the following:

- a) Canadian holders of exchangeable shares will be entitled to the favourable tax treatment that is provided to dividends received from Canadian corporations (tax credits for individuals and generally no tax for corporations).
- b) Canadian holders of exchangeable shares may not be subject to EU withholding tax (if any) on dividends/distributions payable if shares of the EU corporation were held directly.

The Advantages of Using Exchangeable Shares in Canadian Acquisitions

The sale of shares of a target Canadian corporation in exchange for shares of an acquiring Canadian corporation can generally be accomplished on a tax-deferred “rollover” basis by the filing of elections under subsection 85(1) of the *Income Tax Act* (Canada) (the “Act”). These elections defer any capital gain that accrue to the shareholders of the target company until they dispose of the shares they received from the acquirer.

However, this tax-deferred rollover is not available where shares of a Canadian corporation are exchanged for shares of a EU corporation. The inability to provide

The Basic Structure of an Exchangeable Share Transaction

An exchangeable share transaction involving a EU acquiring corporation might be generally structured as follows:

Vancouver

Calgary

Toronto

Montréal

Québec City

New York

London

Johannesburg

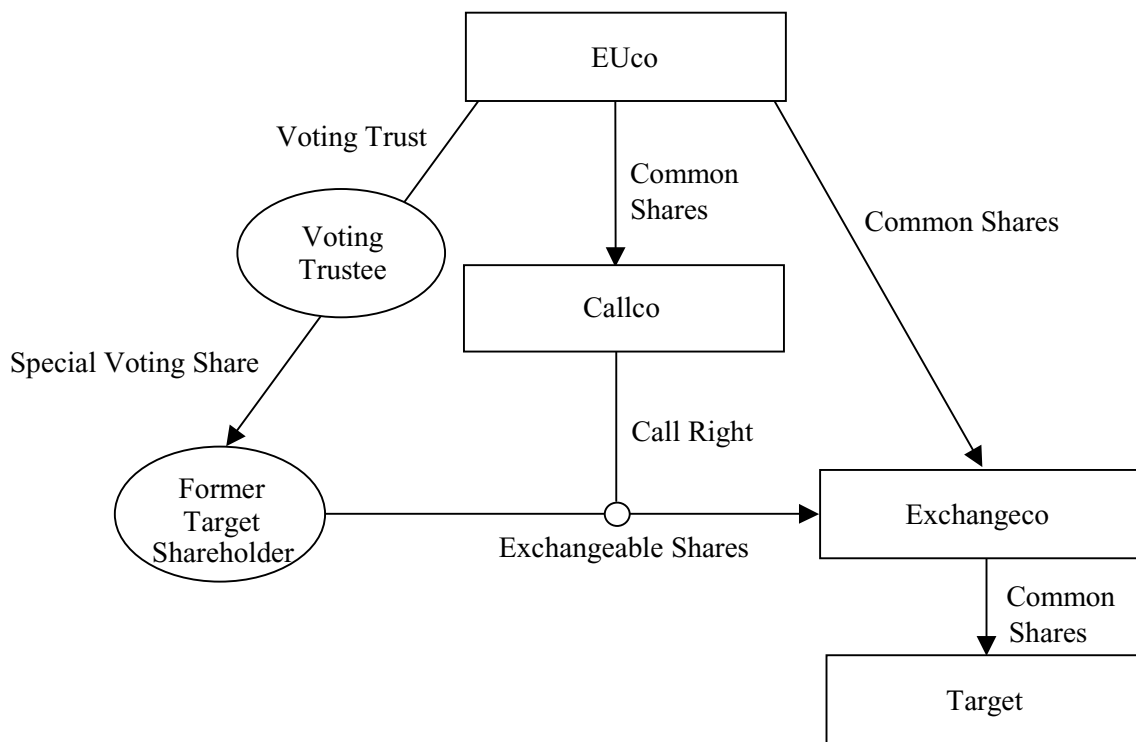
1. **Incorporation of Exchangeco:** A Canadian corporation (“Exchangeco”) is incorporated by a EU acquirer (“EUco”) to acquire the shares of the target Canadian corporation (“Target”) for exchangeable shares (“Exchangeable Shares”) issued by Exchangeco.
2. **Creation of Exchangeable Shares:** For business tax and accounting reasons, the Exchangeable Shares are structured to be the economic equivalent of EUco shares, allowing their holders to participate in the economic success of EUco as though they had received shares of EUco instead of Exchangeable Shares. The share provisions of Exchangeable Shares might have one or more of the following attributes:
 - a) **Dividends/Distributions:** The holders of Exchangeable Shares have a right to dividends (cash, stock or in specie) equal to, and paid contemporaneously with, the dividends/distributions paid by EUco to its shareholders. On the liquidation or dissolution of Exchangeco, holders of Exchangeable Shares are entitled to receive cash or shares of EUco.
 - b) **Voting:** The Exchangeable Shares are non-voting. In addition, the holders of Exchangeable Shares are not shareholders of EUco and therefore are not entitled to vote at meetings of the shareholders of EUco. However, voting rights in EUco could be provided to the holders of Exchangeable Shares through the issuance of a special voting share of EUco carrying the same number of votes as the EUco shares underlying the Exchangeable Shares. This special voting share would be deposited with a trustee and the holders of the Exchangeable Shares would be entitled to direct the trustee to vote the share in accordance with their instructions.
 - c) **Redemption/Retraction:** The Exchangeable Shares are redeemable or retractable (in the case of retraction usually after a fixed date) for cash or shares of EUco (which Exchangeco would normally acquire from EUco). On redemption or retraction, the holder will generally be deemed to have received a taxable dividend equal to the amount by which the value of the shares of EUco exceeds the paid-up capital of the Exchangeable Shares. The Exchangeable Shares will generally be considered to be “short-term preferred shares” for Canadian tax purposes with the result that Exchangeco will be liable to pay a special tax at the rate of 66 2/3% on dividends which are deemed to be paid on a redemption, and on any actual dividends paid as referred to in paragraph (a) above, subject to an annual exemption of \$500,000 of dividends. The dividend tax paid by Exchangeco can be applied to reduce Exchangeco’s, or a subsidiary’s, Canadian tax on operations.
3. **Support Agreement:** EUco enters into a support agreement (the “Support Agreement”) with shareholders of Target pursuant to which EUco agrees to (a) provide financial support to Exchangeco to enable it to pay any dividends or redemption/retraction amounts and (b) issue EUco shares to Exchangeco or a Canadian affiliate of EUco to enable Exchangeco to redeem the Exchangeable Shares or to enable the Canadian affiliate to exercise the Call Right discussed below.
4. **Call Right:** In order to avoid the taxable deemed dividend on a redemption/retraction of Exchangeable Shares, EUco or its Canadian affiliate is granted an overriding right to purchase the Exchangeable Shares for shares of EUco (the “Call Right”). The exercise of the Call Right will result in the holder of the Exchangeable Shares realizing a capital gain (or

loss) to the extent that the value of the shares of EUco exceeds (or is less than) the holder’s cost of the Exchangeable Shares. The holder of the Exchangeable Shares will often prefer capital gains treatment to deemed dividend treatment. Rather than do the exchange directly, which EUco could do, EUco should consider incorporating a Nova Scotia or British Columbia company (“Callco”) as a wholly-owned subsidiary of EUco to exercise the Call Right. One of the reasons for using a Nova Scotia or

British Columbia company is that, unlike the corporate legislation of most Canadian jurisdictions, the Nova Scotia or British Columbia corporate statutes permit a subsidiary to hold shares of its parent, which Callco would need to do in order to satisfy the obligation under the Call Right.

A basic exchangeable share structure might look like the following:

CROSS-BORDER SHARE EXCHANGE ACQUISITION STRUCTURE



Securities Issues and Exchangeable Share Transactions

The impact of Canadian securities legislation must be considered in connection with the various share issuances and transfers involved in an exchangeable share transaction. As a general rule, unless specifically exempted, there is a prohibition under Canadian provincial securities laws in trading in securities without registration as a dealer or in distributing securities which are not qualified by a prospectus. The three problematic issuances and transfers in an exchangeable share transaction are as follows:

- a) the issue of EUco shares to Callco;
- b) the transfer of EUco shares to Target shareholders for their Exchangeable Shares; and
- c) the resale of EUco shares by Target shareholders.

Issue of EUco Shares to Callco and Transfer of EUco Shares to Target Shareholders for Exchangeable Shares

While exemptive relief was previously required for these transactions depending on circumstances such as the residency of the parties, their positions with the Target and the percentage of shares being sold, the Ontario Securities Commission has published a policy which permits the transactions to proceed without exemptive relief based on the takeover bid exemption, even where the transactions take place months or years after the initial bid. While this policy does not have force of law, we believe the reasoning to be sound.

Resale of EUco Shares by Target Shareholders

Assuming that EUco is not a “reporting issuer” in Canada (i.e., EUco has not filed a prospectus in any Canadian jurisdiction), because the EUco shares acquired by Target shareholders will not have been qualified by a prospectus filed in Canada there will be an indefinite “hold period” on the resale of the EUco shares by Target shareholders. This hold

period arises notwithstanding the fact that EUco may be a public corporation in the EU and the fact that Target shareholders would likely be selling their EUco shares into the EU market.

In order to terminate or shorten this hold period, one of the following options should be considered:

- a) EUco can file a prospectus in applicable Canadian jurisdictions which will result in EUco becoming a reporting issuer thereby enabling the EUco shares to be sold four months later (this option has the disadvantage of requiring EUco to thereafter comply with Canadian reporting requirements);
- b) the EUco shares may be sold under a prospectus and registration exemption (for example, the “accredited investor” exemption), although the pool of potential investors may be limited;
- c) a “de minimus” exemption is available where Canadian residents own, directly or indirectly, less than 10% of EUco shares, represent in number fewer than 10% of EUco shareholders and the trade is made on a non-Canadian market or to a non-Canadian buyer; or
- d) discretionary relief can be applied for from securities regulators in applicable Canadian jurisdictions.

Conclusion

The ability of EU corporations to acquire the shares of Canadian corporations is greatly facilitated by the use of exchangeable shares, thereby levelling the playing field with Canadian acquirers who can take advantage of tax-deferred rollovers in the Act.

You are encouraged to contact the writer if you wish to discuss these issues further.

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