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FTC IMPOSES RECORD FINE ON TEXAS ENERGY COMPANIES FOR HSR "GUN JUMPING"

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In early January, the Federal Trade Commission ("FTC") announced that Texas energy companies have agreed to pay a record $5.6 million civil penalty to settle allegations they engaged in pre-merger coordination, known as gun jumping, in violation of the Hart-Scott-Rodino Act ("HSR Act"). During antitrust review between M&A signing and closing, HSR rules restrict an acquiror from beginning to control the target's business.

Government is closely watching transaction parties' adherence to gun-jumping rules. This new action led to a significant fine for pre-closing conduct, including allegations of early control of the target; aggressive pre-closing covenants; and loose information sharing. Compliance with antitrust protocols limits legal risk and potential penalties, especially where the deal may raise information-exchange or other gun-jumping issues.

"Gun jumping" is an enforcement priority for the Department of Justice and Federal Trade Commission. A recent enforcement action against three Texas oil producers challenged several types of alleged gun jumping that the government emphasizes companies should avoid between signing and closing a merger or acquisition.

The federal merger notification statute, the HSR Act, requires parties to large M&A transactions to make "HSR" filings and delay closing to allow the government an opportunity to review their transaction under substantive antitrust law. The HSR waiting period lasts 30-60 days, unless the government extends its investigation by issuing a "second request" for additional information. Until that waiting period expires, an acquiror cannot take "beneficial ownership," including by allowing the acquiring company to begin to exercise control over the target's operations—"gun jumping"—whether or not that will have an anticompetitive effect.

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EXCHANGEABLE SHARE STRUCTURES IN CROSS-BORDER M&A: WHAT U.S. BUYERS OF A CANADIAN TARGET SHOULD KNOW

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Exchangeable share structures can be a tax-efficient way for U.S. buyers to offer equity consideration to a Canadian seller, and are a valuable tool for U.S. buyers considering the acquisition of a Canadian target. This is particularly true for U.S. private equity buyers, as an exchangeable share structure can help facilitate the rollover of a Canadian seller's equity.

As Canada is regularly among the top five destinations for outbound U.S. transactions by both deal value and volume, we provide a concise overview of this tried and tested deal mechanism that has been a common feature of U.S. investment into Canada for several decades. We also explain why U.S. dealmakers should be familiar with the structure to remain competitive with any Canadian bidders interested in the same target.

Tax-Deferred Treatment

The impetus for a U.S. buyer of a Canadian target agreeing to an exchangeable share structure is tax based. A sale of shares in a Canadian company by a Canadian-resident shareholder, in exchange for shares of a Canadian entity, whether a corporation or a partnership (with only Canadian-resident partners), is generally eligible for tax-deferred treatment when the appropriate election is made under the *Income Tax Act* (Canada).

Where this election is unavailable or otherwise not made, a Canadian resident who disposes of shares of a Canadian company will be considered to have disposed of such shares for proceeds of disposition equal to the fair market value, at the time of the disposition, of the shares acquired in the exchange.

By contrast, Canadian-resident shareholders cannot exchange shares of a Canadian corporation for shares of a U.S. (or other foreign) buyer on a tax-deferred basis under Canadian tax law. Without an exchangeable share structure, Canadian sellers could find themselves with tax liability, while at the same time receiving U.S. buyer stock with little or no liquidity.

The primary benefit for the U.S. buyer is therefore a means to increase the attractiveness of its bid to the Canadian sellers and/or to remain competitive with any Canadian bidders interested in the same target. The primary benefit for the Canadian seller(s) is the ability to secure deferral of Canadian capital gains taxes on the equity consideration received for the sale of the Canadian target to the U.S. buyer. The tax-deferral lasts until the exchangeable shares are exchanged for the corresponding stock in the U.S. buyer, typically on a liquidity event of the buyer (such as a change of control or listing).

U.S. Private Equity Buyers

For private equity buyers, this exchangeable share structure offers the same benefits rollover equity brings, providing: (1) a means to help bridge any valuation gap between the parties, (2) better alignment between management and the sponsor going forward, and (3) improved financing terms through a reduced closing cash payment and lower leverage. Also, if desired, exchangeable shares can be structured to be exchangeable into limited partnership or LLC membership interests, rather than shares of a corporate buyer.

Structure, Entities and Material Rights

An exchangeable share structure can be implemented in different ways, but the essential objective is to provide the Canadian seller(s) with shares in a new Canadian corporation that are the economic equivalent of stock in

the U.S. buyer (*i.e.*, which mirror all rights attaching to the U.S. buyer's stock, including dividend and liquidation entitlements).

The structure is achieved through the incorporation of two new Canadian corporate entities. First, a direct Canadian subsidiary of the U.S. buyer, typically called "CallCo." Second, a Canadian subsidiary of CallCo or the U.S. buyer, typically called "ExchangeCo."

Upon acquiring the Canadian target, ExchangeCo issues the exchangeable shares—on a tax-deferred basis—to the Canadian sellers. Thereafter, upon any liquidation or dissolution event of the U.S. buyer, the Canadian sellers are entitled to exchange the exchangeable shares for stock in the U.S. buyer on a one-for-one basis. The Canadian sellers are also provided a "retraction right" whereby they can require that ExchangeCo redeem the exchangeable shares for stock in the U.S. buyer on the same basis. Similarly, ExchangeCo has a "redemption right" whereby it can redeem the exchangeable shares, in certain limited circumstances, on the same basis.

CallCo is also provided with an "overriding call right," entitling it to purchase the exchangeable shares from the Canadian sellers in exchange for stock in the U.S. buyer on a one-for-one basis. This purchase right may be preferable to redemption—whether in the case of a liquidation event, retraction or redemption—for avoiding adverse Canadian deemed dividend tax consequences to the Canadian sellers that may arise upon a redemption of the exchangeable shares.

Key Deal Points and Documents

Because the Canadian seller(s) will effectively become stockholder(s) of the U.S. buyer, acquirors should expect corresponding due diligence by the Canadian seller(s), including the review and negotiation of shareholder agreements to which the U.S. buyer is a party, ExchangeCo's constating documents, and the "support and exchange agreement" (discussed below). Due diligence is also necessary to ensure proper alignment from a mechanical perspective.

Key negotiation points can include whether the sellers will be granted, where reasonably viable, special voting rights in the U.S. buyer to put them on the same footing as regular holders of the U.S. buyer's stock, such as through the issuance by the U.S. buyer of special voting stock to a share trustee (or other intermediary), who will hold the special voting shares on behalf of the Canadian sellers. The Canadian sellers, through a share trustee (or other intermediary), may also desire to be made a party to any stockholder (or similar) agreement of the U.S. buyer. The intent here is for the Canadian sellers to benefit from material stockholder rights under such agreements (*e.g.*, rights of first refusal, tag-along rights, access to information rights, and liquidity rights). The U.S. buyer and Canadian sellers may also desire a sunset clause whereby an exchange of the shares is automatically triggered after a set period of time (*e.g.*, 10 years) or upon specified events such as prior to an initial public offering or an adverse change in tax laws.

The Canadian sellers, CallCo and ExchangeCo typically enter into a "support and exchange agreement" with the U.S. buyer. The key terms under this agreement include undertakings by the U.S. buyer to (1) provide ExchangeCo with sufficient funds to pay the Canadian sellers dividends equal to those paid to regular stockholders of the U.S. buyer, and (2) issue stock in itself to satisfy the exchange of the exchangeable shares into its stock, whether upon a liquidation event or the exercise of the seller's retraction right, ExchangeCo's redemption right, or CallCo's call right.

Advantages and Disadvantages

Before deciding to adopt an exchangeable share structure, their advantages and disadvantages in the particular circumstances should be weighed and balanced. At a high level, these include:

Advantages:

- Canadian sellers enjoy the option of tax deferral on the share consideration received, while preserving an economic interest equivalent to direct ownership in the U.S. buyer.

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- It is still possible for U.S. buyers to provide mixed consideration that includes the desired combination of taxable securities of the U.S. buyer and tax-deferred shares of ExchangeCo, which can be desirable when Canadian sellers have tax losses.
- Achieves similar tax treatment between Canadian-resident sellers (who are not otherwise entitled to a tax deferral) and non-Canadian sellers who may be entitled to a tax deferral.
- If properly structured, may allow for earnout/reverse earnout mechanisms to be layered into the acquisition structure while preserving tax deferral for the Canadian sellers.

Disadvantages:

- Exchangeable share structures increase transaction complexity and add costs related to implementation and maintenance, including accounting implications.
- Some sellers may not benefit from the structure's advantages, including non-taxable and non-resident entities and Canadian residents able to deduct losses against the capital gains realized.
- Some additional future complexity is added, *i.e.,* in connection with unwinding the structure or potentially preserving it should any Canadian rollover shareholders be rolled over again.
- Additional considerations and structures may be required to deal with other securities, such as convertible notes issued by the Canadian target, that are to remain outstanding following the closing of the transaction.[1]

Concluding Comments

Canadian buyers are able to offer Canadian sellers equity on a tax deferred basis. As such, to remain competitive in the Canadian market, and particularly in a competitive bid scenario, prospective U.S. buyers should familiarize themselves with exchangeable share structures and the planning, buyer due diligence, and associated negotiation points and deal documents necessary to implement them.

While adopting an exchangeable share structure increases transaction costs, these additional costs may be offset by the competitive gains attained and other potential attendant benefits such as a smaller cash component of the purchase price, reduced debt financing costs and, in the case of a U.S. private equity buyer, synergy between the exchangeable share structure and rollover equity.

ENDNOTES:

[1]For example, by amending the terms of such securities to allow them to be converted into shares of the U.S. buyer (where a taxable transaction is desired) or ExchangeCo (where a tax-deferred transaction is desired)

SECTION 205: INTENT MATTERS

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In late August 2024, Vice Chancellor Lori W. Will of the Delaware Court of Chancery issued an opinion in *Falcon I, LLC, et al. v. Golden Mountain Financial Holdings, et al*[1] that will guide corporate counsel and their clients on the use of Section 205 petitions to cure defective corporate acts.

In *Falcon*, private equity fund TS Falcon I notified the Golden Mountain board of its intent to exercise its option to increase its stake in Golden Mountain.[2] Three days later, the Golden Mountain board met in executive session, excluding Falcon's observers, and resolved to reschedule the Golden Mountain annual meeting and set the record date to one day before Falcon attempted to exercise its option.[3] Falcon sued Golden Mountain and its board, seeking a declaration of its voting power under 8 *Del. C.* § 225 and asserting a violation of the annual meeting statute, 8 *Del. C.* § 213(a).[4] As the trial record

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