Canadian Cross-Border Transactions Using Exchangeable Shares

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The doors to foreign investment in Canada have been wide open for a long time, notwithstanding the Canadian government's recent rejection of BHP Billiton Ltd.'s bid for Potash Corp. of Canada. Foreign buyers often wish to pay for the target Canadian company with their shares or a combination of shares and cash. And many sellers are more than happy to take share consideration, particularly publicly-traded shares of companies with attractive growth prospects.

Unfortunately, non-Canadian acquirers do not start on a level playing field with Canadian acquirers because certain Canadian tax deferral provisions are currently only available to Canadian acquirers. But there is a solution: the use of exchangeable shares issued by a Canadian subsidiary of the foreign acquirer to facilitate its Canadian acquisition.

This article examines the advantages of using exchangeable shares, describes the basic structure of an exchangeable share transaction and addresses key corporate, tax and securities issues that arise in connection with this type of transaction.

Advantages of Using Exchangeable Shares in Canadian Acquisitions

When a Canadian corporation uses its shares to acquire shares of another Canadian corporation, a seller can normally defer the tax arising on the disposition by filing the appropriate tax election. This election defers the seller's capital gain on the sale until the seller ultimately sells the shares of the buyer.

This deferral is not available where shares of a Canadian corporation are exchanged directly for shares of a non-Canadian corporation. So an exchangeable share structure, whereby the non-Canadian corporation uses a Canadian affiliate to acquire the target corporation, is needed to provide the rollover. The exchangeable share structure also provides the added benefit of reducing Canadian withholding tax on distributions out of Canada.

The Basic Structure of an Exchangeable Share Transaction

The following is a typical exchangeable share structure for a U.S. corporation (USco) to acquire the shares of a Canadian target in exchange for USco shares.

Incorporation of Exchangeco and Callco

USco incorporates two Canadian subsidiaries: one corporation (Exchangeco) to acquire the target shares and a second corporation (Callco) to exercise the "call right" described below. To reduce withholding tax on distributions from Canada, Callco should own all of the shares of Exchangeco and USco should directly or indirectly own all of the shares of Callco.

It should be noted that USco can itself exercise the call right. But including Callco in the structure can reduce cross-border withholding tax (currently 5%) on the repatriation of funds from the target to USco.

Creation of Exchangeable Shares

For business, tax and accounting reasons, the exchangeable shares are structured to be the economic equivalent of the USco shares, allowing the sellers to participate in the economic success of USco as though they had received USco shares instead of exchangeable shares. The share provisions of exchangeable shares generally have the following attributes:

(a) Redemption/Retraction

Sellers can redeem exchangeable shares, or Exchangeco can retract them in limited circumstances (generally after an agreed number of years, at such time as a de minimus number of exchangeable shares are outstanding, or in the event of a change of control of USco), for USco shares on a one-for-one basis. There are adverse tax consequences to both the sellers and Exchangeco arising from a redemption or retraction. These consequences can be avoided by Callco's exercise of its "call right."

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(b) Dividends/Liquidation Distributions

The sellers have a right to receive dividends equal to, and paid concurrently with, dividends paid by USco to its shareholders. On the liquidation or dissolution of Exchangeco, sellers are entitled to receive USco shares from USco or Exchangeco subject to Callco's "call right."

Whatever the final structure, using exchangeable shares greatly facilitates the ability of U.S. and other foreign corporations to acquire shares in Canadian corporations.

(c) Voting

The exchangeable shares are non-voting, but sellers are granted the right to vote at meetings of USco shareholders through the issuance of either:

- a special voting share of USco carrying the same number of votes in aggregate as the USco shares underlying the exchangeable shares (such special share typically deposited with a trustee who will vote the share in accordance with the instructions of the sellers), or
- a number of special voting USco shares equal to the number of outstanding exchangeable shares, particularly where the number of sellers is relatively small, such shares to be automatically cancelled on a one-for-one basis as exchangeable shares are exchanged for USco shares.

In either case, USco must issue a new class of voting shares prior to the closing of the exchangeable share transaction. However, creating a new class of shares requires USco shareholder approval which may not be economically practicable or even possible on a timely basis, particularly where USco is a public company.

Timing is not a problem where USco has received shareholder approval previously for the creation of a class of "blank check preferred stock", whose terms and conditions may be expressly determined by USco's board of directors in its discretion. In such case, a series of these preferred shares can be authorized and issued without further recourse to USco's shareholders for use as either a single special voting share or as a number of voting shares equal to the number of exchangeable shares.

Call Right

As mentioned, to avoid the adverse tax consequences arising from a redemption/retraction of exchangeable shares, Callco is granted an overriding call right to purchase the exchangeable shares from the sellers for USco shares. The exercise of the call right results in sellers realizing a capital gain (or loss) to the extent that the value of the USco shares exceeds (or is less than) their cost base in their exchangeable shares (being the same as their cost base in their shares of the target).

It should be noted that USco can itself exercise the call right. But including Callco in the structure can reduce cross-border withholding tax (currently 5%) on the repatriation of funds from the target to USco. This is because the paid-up capital on Callco's shares, initially nominal on incorporation, increase as Callco issues its shares in connection with the exercise of its "call right." Callco can distribute the target's excess cash to USco free of withholding tax until its aggregate distributions exceed the increasingly high paid-up capital of its shares.

Support Agreement

USco enters into a support agreement with the sellers pursuant to which USco agrees to, among other things:

- provide financial support to Exchangeco to enable it to pay any dividends or redemption/retraction amounts to the sellers, and
- issue USco shares to the sellers to support Exchangeco's redemption of the exchangeable shares or Callco's exercise of its call right.

Callco can distribute the target's excess cash to USco free of withholding tax until its aggregate distributions exceed the increasingly high paid-up capital of its shares.

Securities Issues

The impact of Canadian securities legislation must be considered in connection with the various share issuances and transfers involved in an exchangeable share transaction. While Canadian securities regulators exempt such share issuances and transfers, including the transfer of USco shares to sellers for their exchangeable shares (see Companion Policy to NI 45-106 - Prospectus Exempt Distributions), the resale of USco shares by sellers is more problematic. There is an indefinite "hold period" on the resale of the USco shares by the sellers absent an available resale exemption. This hold period arises notwithstanding the fact that USco may be a publicly listed corporation and the sellers are therefore likely selling their USco shares on a recognized US stock exchange.

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Resale exemptions include sales to an "accredited investor" or the "de minimus" exemption. But this is only available where Canadian residents own, directly or indirectly, less than 10% of USco shares, represent in number fewer than 10% of USco shareholders and the trade is made on a non-Canadian market or to a non-Canadian buyer.

U.S. securities laws also affect the sellers. Among other things, the sellers are subject to a six-month hold period under Rule 144 on their receipt of the USco shares, although is not uncommon for the sellers to agree to restrict their ability to sell USco shares for a period in excess of the hold period to ensure an orderly market is maintained for USco shares. Sellers that have capital gains tax to pay as a result of acquiring USco shares, and intend to pay the tax out of the proceeds from the sale of the USco shares, should be careful to ensure that any statutory or contractual holding period expires prior to the date that they need to sell the USco shares to pay their tax or take advantage of any capital loss.

The Bottom Line

This article is intended to be an overview of a cross-border exchangeable share structure. Of course, each transaction is different and the structure can be tailored as needed to balance the interests of the acquirer and the sellers. For example, it may be more tax effective, particularly where a seller is a corporation, to create Exchangeco as a Canadian limited partnership rather than as a corporation. And where sellers hold stock options in a non-public target, there may be advantages to reorganizing the shares of the target to be acquired into two separate classes to ensure the continuation of available option tax deferrals.

Whatever the final structure, using exchangeable shares greatly facilitates the ability of U.S. and other foreign corporations to acquire shares in Canadian corporations. ❏

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