

Conclusion

There continue to be problems with the enforcement of obligations in the continuous disclosure regime stemming largely from the different and confusing use of materiality found in the various continuous disclosure provisions of the Act. As evidenced by the examples of *Pezim*, *Maxwell* and *Fingold*, this confusion can lead to unpredictable and inconsistent results from the courts and unclear directions being provided by the OSC respecting its interpretation of the legislation. It is not unfair to suggest that such inconsistency also leads to uncertainty which manifests itself in disclosure which is less than "full, true and plain."

The proposed amendments do not improve matters much unless the Commission decides to stop prosecuting continuous disclosure and insider trading violations in the criminal courts. The Commission should turn its attention to the fundamental inconsistencies in the Act itself and decide whether to link materiality, for all purposes, to a market effects test. As an alternative they could abandon the market price and value test altogether for a *Northway* type approach, but only if they reassess the use, and possibly the overuse, of prosecutions as a regulatory response to disclosure problems. As with many other areas of life, a wink can sometimes be as good as a nod to a market participant.

CROSS-BORDER ACQUISITIONS

Structuring Cross-Border Acquisitions: Exchangeable Shares

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Introduction

Exchangeable shares have become a common method of effecting cross-border acquisitions of Canadian businesses by U.S. public companies in circumstances where the U.S. acquirer wishes to obtain U.S. pooling treatment for the transaction and the Canadian vendor wishes to achieve a tax-deferred share exchange. Exchangeable share structures are used most frequently in cases where a U.S. public company is acquiring a Canadian high technology company or other company without a history of earnings. Generally, the structure is available only where a pre-closing reorganization of the Canadian target company is not required to achieve optimal tax results for the vendor and where the U.S. acquirer does not have or anticipate implementing a policy of paying regular dividends on its common shares. In the case of the acquisition of Canadian companies in traditional industries, where the company typically has a significant earnings history and is often very narrowly held (often by owner/entrepreneurs and their immediate family members), the Canadian vendor's desire to engage in tax-effective pre-closing reorganization transactions may preclude the use of an Exchangeable Share transaction to achieve U.S. pooling treatment.¹

¹ For example, where a Canadian controlled private corporation has accumulated tax-paid retained earnings, a typical pre-closing transaction will involve the distribution of these tax-paid retained earnings to a holding company prior to closing to defer tax on their distribution. Similarly, the company's assets may include assets not integral to the business being sold, and the parties

Typical Transaction Structures

In the typical exchangeable share transaction, a U.S. public company ("U.S. Acquireco") will purchase the shares of a Canadian acquisition target ("Canadian Targetco") from Canadian resident shareholders (the "Canadian Vendor") pursuant to a share-for-share exchange transaction using shares ("Exchangeable Shares") of a Canadian subsidiary ("Canadian Subco") of U.S. Acquireco.² The Exchangeable Shares are exchangeable for shares of U.S. Acquireco ("U.S. Acquireco Shares") and are designed to be the economic equivalent of the U.S. Acquireco Shares. Alternatively, in some transactions, the capital of Canadian Targetco will be reorganized to convert the Canadian Vendor's shares to Exchangeable Shares, with U.S. Acquireco becoming the sole holder of common shares of Canadian Targetco.

Advantages

U.S. Acquireco's Perspective

From the perspective of U.S. Acquireco, the use of Exchangeable Shares has three advantages:

- (i) it permits the indirect use of U.S. Acquireco's publicly traded shares as a non-cash acquisition currency for Canadian transactions;

will desire that these be distributed to another entity pre-closing. Such pre-closing reorganizations will taint pooling treatment of the acquisition under U.S. accounting rules by offending the rule which prohibits changes in the equity interests (including the payment of dividends) in either corporation in contemplation of the combination of the companies.

² For an excellent review of the Canadian tax considerations applicable to structuring Exchangeable Share transactions, see R. Ian Crosbie, "Canadian Income Tax Issues Relating to Cross-Border Share Exchange Transactions," Canadian Tax Foundation, Corporate Management Tax Conference, 1997. See also, Monica Biringer, "The Use of Exchangeable Shares in the Acquisition of Canadian Software Companies," Canadian Tax Foundation, 47th Annual Tax Conference, 1995 Conference Reports. While Revenue Canada advance tax rulings are not generally sought in respect of Exchangeable Share transactions, Revenue Canada has issued favourable rulings on the typical transaction structure, including favourable opinions with respect to the general anti-avoidance rule. Revenue does not, however, provide valuation opinions and therefore does not opine on the issue of whether support arrangements constitute "boot."

- (ii) it allows U.S. Acquireco to preserve pooling treatment of the acquisition for U.S. accounting purposes, permitting more attractive pricing of the transaction;³ and
- (iii) it allows U.S. Acquireco to offer a tax-deferred structure to Canadian Vendors, again permitting more attractive pricing.

Canadian Vendor's Perspective

The use of Exchangeable Shares permits a Canadian Vendor willing to indirectly hold common shares of U.S. Acquireco to defer tax on the disposition of his shares in Targetco. This is accomplished by making available to the Canadian Vendor the elective rollover provisions under sections 85 and 85.1 of the Income Tax Act⁴ which permit a Canadian Vendor to delay gain on a share exchange between Canadian companies until the ultimate sale of the shares received in the exchange.⁵ Such rollover provisions are not available in the case of a direct disposition of shares of a Canadian company in exchange for shares of a non-resident acquiror.

Capital Structure

In a typical Exchangeable Share transaction, the capital structure of Canadian Subco will consist of three classes of shares:

- (a) *Common Shares*: a class of common shares authorized in an unlimited number with all of the issued and outstanding common shares being held by U.S. Acquireco (thus assuring control of Canadian Subco by U.S. Acquireco);
- (b) *Senior Preferred Shares*: a class of senior preferred shares authorized in an unlimited number which will be used by

³ Pooling of interests accounting under U.S. GAAP permits the acquiror to: (i) carry forward the assets, liabilities and retained earnings of the target company at their historical carrying amounts without being required to record any excess of the amount paid for the target shares over the book value of its assets as goodwill and amortized as an expense against income as is required under the purchase method accounting rules; and (ii) restate the historical operating results of the two companies for prior periods on a combined basis.

⁴ RSC 1985, c. 1 (5th Supplement), as amended.

⁵ Generally, the Vendor will elect to realize only such gain as can be realized tax-free under the \$500,000 capital gains exemption under section 110.6 of the Income Tax Act applicable to shares of eligible small business corporations.

U.S. Acquireco to capitalize Canadian Subco. Capitalizing through this class of shares will permit U.S. Acquireco to return capital to the U.S. without the imposition of Canadian withholding tax and will provide U.S. Acquireco with a priority ranking in respect of its capital contributions over holders of the Exchangeable Shares; and

- (c) *Exchangeable Shares*: a class of "blank cheque," subordinate, non-voting preferred shares authorized in an unlimited number and to be used by Canadian Targetco as acquisition currency in Canadian acquisitions which proceed, wholly or partially, by way of a share exchange.

Economic Equivalency: The Exchangeable Shares will be structured to be the economic equivalent of the U.S. Acquireco Shares; i.e., they will be entitled to dividend, liquidation and voting rights equivalent to the U.S. Acquireco Shares into which they are exchangeable. This is necessary both to ensure their commercial acceptability to the Canadian Vendor and to ensure pooling treatment of the acquisition for U.S. Acquireco under U.S. accounting rules. Typically, the number of Exchangeable Shares issued in exchange for each outstanding share of Canadian Targetco will be set such that, following the transaction, the Exchangeable Shares will be exchangeable for U.S. Acquireco Shares on a one-for-one basis. The Exchangeable Share terms will contain typical anti-dilution provisions to ensure that the economic interests of the holders of Exchangeable Shares will not be adversely affected by stock splits, stock dividends and the like.

Redemption/Retraction: Typically, the Exchangeable Shares will be retractable by the Canadian Vendor at any time at a price equal to the value, at the time of retraction, of the U.S. Acquireco Shares into which they may be exchanged and will provide that the retraction price may be satisfied by delivery of U.S. Acquireco Shares. The Exchangeable Shares will also be redeemable by Canadian Subco on a specified sunset date or upon the occurrence of certain events (such as a takeover bid for U.S. Acquireco or when the outstanding Exchangeable Shares fall below a "de minimus" number) for an amount equal to the retraction price, again payable in U.S. Acquireco Shares.

A retraction date of five to seven years after issuance is typical to ensure that U.S. Acquireco's capital structure is not unduly complicated for a prolonged period while at the same time permitting a significant tax deferral period for the Canadian Vendors. If it is anticipated that U.S. Acquireco will not become a dividend-paying company, a long non-retraction period may not be inconvenient. The Exchange Shares will be issuable in series with a different series of shares used in each acquisition, and with the directors of Canadian Subco entitled to attach specific rights and restrictions to each series.

Dividends: The Exchangeable Shares will be entitled to dividends (out of the assets of Canadian Subco properly available for the payment of dividends) and other distributions (including liquidating distributions) in an amount equal to any dividends or other distributions declared on the U.S. Acquireco Shares. However, for technical reasons relating to the Canadian taxable preferred share rules discussed below and U.S. withholding tax considerations, the Exchangeable Share structure works best where U.S. Acquireco does not have a policy of paying regular dividends and does not anticipate paying dividends within the deferral period agreed upon with the Canadian Vendors.

Tax Deferral: Canadian Vendors who exchange their Canadian Targetco shares for Exchangeable Shares will be able to defer tax on up to that portion of their proceeds of disposition exceeding the sum of their adjusted cost base plus cash and other non-share consideration received.

Pooling Treatment

Achieving pooling treatment of the Canadian acquisition for U.S. Acquireco necessarily complicates the Exchangeable Share transaction structure. U.S. pooling treatment requires, among other things, that: (i) 90% of the price paid by the Canadian Targetco shares be payable in Exchangeable Shares; (ii) the holders of Exchangeable Shares have voting rights in U.S. Acquireco through some type of voting trust arrangement; (iii) the Exchangeable Shares must be the economic equivalent of U.S. Acquireco Shares, including an entitlement to dividends; (iv) pre-closing reorganizations of Canadian Targetco, including dividend distributions must be restricted; and (v) the disposition of Exchangeable Shares by the

Canadian Vendors must be prohibited for an interval, typically two to five months after closing.⁶

Collateral Arrangements

Typically, pooling and tax considerations will cause a number of collateral arrangements to be added to this basic Exchangeable Share structure:

1. *Voting Trust Arrangement:* In order for U.S. Acquireco to preserve pooling treatment, the Canadian Vendor must receive voting rights in U.S. Acquireco equivalent to the voting rights of the U.S. Acquireco Shares into which the Exchangeable Shares are exchangeable. Generally, these rights are provided by U.S. Acquireco issuing a single share of a special class of U.S. Acquireco's stock to a trustee. The special share provides the trustee with a number of votes (but no economic rights) exercisable at U.S. Acquireco shareholder meetings equal to the number of Exchangeable Shares outstanding from time to time. The trustee holds these voting rights for the benefit of the holders of Exchangeable Shares, with each such holder entitled to exercise one vote for each Exchangeable Share held. If U.S. Acquireco cannot practically create the special voting share required, for example, because its creation would require approval of U.S. Acquireco's existing shareholders at a special meeting, an alternative structure is for U.S. Acquireco to deposit a number of its

⁶ The requirements for U.S. pooling treatment are set out in Opinion No.16 (APB 16), "Accounting for Business Combinations," of the U.S. Accounting Principles Board. Specifically, in order to qualify for pooling: (i) each of the parties to the transaction must be pre-existing, independent entities with substantial business activities; (ii), the combination must be effected by a single transaction; (iii) only common shares of the acquiring company or securities that are "essentially the same" must be issued for the target's common shares and at least 90% of the target companies' common shares must be acquired in the share exchange; (iv) changes in the equity interest in either company (e.g., dividends, stock issues) in contemplation of the combination are not permitted; (v) shareholders of the target must receive proportionate voting rights in the acquiring company; (vi) disposition of shares by affiliates of either corporation are prohibited after the transaction until financial results with respect to a period of at least 30 days following the transaction have been published.

common shares equivalent to the number of outstanding Exchangeable Shares into a trust, the terms of which stipulate that the voting rights attached to the shares are to be held for the benefit of the holders of Exchangeable Shares but that all other rights with respect to the shares are to be held for the benefit of U.S. Acquireco.

2. *Put/Call Rights.* A typical Exchangeable Share structure will be designed to provide U.S. Acquireco with an overriding right to purchase the Exchangeable Shares directly rather than have them redeemed or retracted by Canadian Subco. The call price will equal the redemption/retraction price, and will be similarly payable in U.S. Acquireco Shares.

The existence of the call right is an imperative, as a technical matter, since the Exchangeable Shares will be treated as "taxable preferred shares" and "short-term preferred shares" under the Income Tax Act. The result of this characterization is that Canadian Subco could be required to pay an additional, albeit refundable, Part VI.1 tax in respect of both dividends and deemed dividends (such as result from a retraction or redemption) paid to holders of the Exchangeable Shares. To the extent that U.S. Acquireco does not anticipate paying dividends, this will be a non-issue with respect to dividends. However, the redemption of the Exchangeable Shares will trigger a deemed dividend to the extent that the adjusted cost base of the Exchangeable Shares is below the redemption amount. This will typically be the case, both as a result of the Exchangeable Shares having a low cost base resulting from the shares being issued in the share exchange pursuant to a tax deferred rollover and second, as a result of the likelihood of U.S. Acquireco shares increasing in value over time. Although the Part VI.1 tax is a potentially significant substantial tax liability, it is a creditable tax which can be applied against other taxes owing by the Canadian subsidiary or other related Canadian corporations within the corporate family. The risk of the imposition of this tax liability is alleviated or eliminated through the addition of the call right feature. If it is anticipated that a redemption or retraction

would occur and would trigger Part VI.1 tax, U.S. Acquireco will elect to exercise its call rights to purchase the Exchangeable Shares rather than have them redeemed by Canadian Subco.⁷

The existence of the put right protects the entitlement of the Canadian Vendors to acquire U.S. Acquireco shares in the future by ensuring that they will have the right to put their Exchangeable Shares directly to U.S. Acquireco for U.S. Acquireco Shares in circumstances where Canadian Subco cannot retract or redeem the shares because, for example, it cannot pass the solvency tests applicable to share redemptions in its corporate statute. As another feature, the Exchange Shares will be automatically exchanged into Canadian Subco shares in a liquidation of U.S. Acquireco so that the holders can participate in liquidating distributions.

3. *Support Agreement.* Another element of a typical Exchangeable Share transaction is a support agreement between U.S. Acquireco and Canadian Subco in which U.S. Acquireco agrees to ensure that Canadian Subco will be funded with sufficient resources (including U.S. Acquireco common shares) to permit it to satisfy its dividend and retraction obligations with respect to the Exchangeable Shares and to ensure that U.S. Acquireco will not take actions that prejudice holders of Exchangeable Shares, by diminishing the value of that which they are entitled to receive on the retraction or redemption of their shares.

As a technical matter, put or support rights, to the extent that economic value may be considered as non-share consideration (or "boot") in the share exchange rollover transaction and, if so, will constrain the Canadian Vendor's ability to shelter the entire capital gain on its disposition of Canadian Targetco Shares through the rollover elections. For this reason, the Canadian Vendors will not be

⁷ The tax consequences of the purchases by U.S. Acquireco differ from the tax consequences of a redemption by Canadian Subco. The former results in capital gains treatment to the extent that proceeds exceed acquisition cost whereas the latter results in a deemed dividend to the extent that the redemption exceeds paid up capital.

included as parties to the support agreement and any tax opinion will be based on a representation of the parties that they believe this "boot" to be of nominal value. The Support Agreement will prohibit U.S. Acquireco from changing its common stock (e.g., share splits or consolidations), granting in specie dividends or entering into mergers, etc., unless the economically equivalent change, distribution or transaction is offered to holders of Exchangeable Shares.

Further, the Canadian Vendor may insist that the Support Agreement prohibit U.S. Acquireco from declaring or paying dividends or other distributions unless Canadian Subco is in a position to declare and make equivalent distributions. It is also likely that the Support Agreement will contain covenants by U.S. Acquireco not to vote Exchangeable Shares held by it in cases where the Exchangeable Shares may be statutory entitled to a class vote and not to liquidate, windup or dissolve Canadian Subco while there are Exchange Shares outstanding. Approval of the holders of Exchangeable Shares will be required for other than administrative changes to the Support Agreement which may be prejudicial to the holders of Exchangeable Shares.

4. *Listing and RRSP Eligibility:* If it is anticipated that the Canadian Vendors will include non-taxable or other institutional investors, it will be necessary for Canadian Subco to be a public corporation listed on a prescribed exchange in Canada. This is only necessary in any case where the Canadian Vendors of Canadian Targetco are institutional investors which are subject to investment restrictions which limit the amount of foreign property in which they invest. In such cases, it will be necessary to list the Exchangeable Shares to ensure that they are a qualified investment not characterized as foreign property. Otherwise, institutional holders of target shares could be driven by the foreign property characterization to sell off their Exchangeable Shares immediately after the transaction. This would jeopardize pooling treatment by offending the U.S. accounting requirement that prohibits affiliates from selling or otherwise reducing risk relative

to any common shares received on the merger transaction until financial results with respect to a period of at least 30 days following the merger had been published.

Securities Law Considerations

Canadian and U.S. securities law will be applicable to the issuance or subsequent transfer of the Exchangeable Shares, unless exemptions are available. From a Canadian perspective, an Exchangeable Share transaction involves multiple issuances of securities, including not only the issuance of the Exchangeable Shares themselves, but also the issuance of the various exchange, put and retraction rights to the Canadian Vendors and the issuance of call rights to U.S. Acquireco, as well as the various issuances of U.S. Acquireco Shares under the Support Agreement or pursuant to the exercise of put or call rights. Specifically, no registration or prospectus exemptions are available in Canada for the transfer of the Exchangeable Shares upon possible exercise of the various rights, or for the various possible issuances of U.S. Acquireco Shares, or for the first trades subsequently of such U.S. Acquireco Shares. Canadian securities administrators, however, routinely issue exemption orders to cover such trades where U.S. Acquireco is registered under the *Securities Act of 1934* and the Canadian Vendors are provided with all disclosure materials furnished to U.S. shareholders of U.S. Acquireco.⁸

From a U.S. perspective, the U.S. Acquireco Shares issued to Canadian Subco under the support agreement or directly to holders of Exchangeable Shares under the Exchange Agreement will typically either be registered under an acquisition shelf registration statement or pursuant to applicable exemptions under Regulation S or Rule 144.

⁸ See, for example, *In the Matter of Ontario Tree Fruits Limited and Trio Importing*, (1998) OSCB 2891.

Conclusion

U.S. accounting rules applicable to poolings of interest are substantially more lenient than the accounting rules of Canada and many other countries in permitting pooling treatment for acquisitions. Canada, for example, requires a "merger of equals" as one of the critical pre-conditions to achieve pooling of interest treatment of a merger.⁹ Therefore, notwithstanding some recent high profile examples to the contrary, there are very few instances where Canadian only mergers are accounted for on a pooling of interest basis. U.S. accounting rules are distinctly different, and so long as this remains the case, Exchangeable Share transactions will remain a popular method of structuring the acquisition of Canadian targets by U.S. companies.¹⁰ Two recent SEC actions, however, indicate a tightening of the SEC regulation of pooling transactions.¹¹ In each case, the issuer breached SEC rules prohibiting stock buy-backs within two years prior to a merger or within six months after. There has also been speculation that the U.S. Financial Accounting Standards Board will eliminate poolings, but allow companies to record goodwill indefinitely and only take write-offs where these assets decline in value. Until such changes are enacted, however, Exchangeable Shares will remain a popular Canada/U.S. cross-border acquisition technique.

⁹ Specifically, the larger party must represent no more than 55% in value of the transaction and the smaller party no more than 45% of the value.

¹⁰ A recent prominent example is the acquisition of Midland Securities by Merrill Lynch.

¹¹ In these recent transactions, U.S. Office Products purchased about \$1 billion of its stock or 23% of its total outstanding shares, barely six months after closing 22 pooling transactions and Corporate Express similarly repurchased 35 million of its shares, or 25% of total outstanding. As a result, U.S. Office Products was required to book \$422.8 million of goodwill charges, a \$10.6 million annual earnings hit over 40 years, and Corporate Express was required to book goodwill of \$130.4 million, an annual hit of \$3.3 million.

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