

Transformational US Acquisitions by Canadian Income Funds: The Next Wave in Cross-Border Income Securities?

By Philip Brown, Richard Willoughby and Alexandra Kau
Torys LLP

I. Cross-Border Income Securities: Then and Now

A new category of securities is taking shape that adapts the Canadian income fund structure for application to US businesses. This category, which the authors refer to as cross-border income securities, has seen evolutionary waves, including cross-border income funds, Income Deposit Securities (IDSs), or Enhanced Income Securities, and Income Participating Securities (IPs)—and now perhaps a next wave in the form of transformational US acquisitions by Canadian income funds.

Two such deals recently closed. In April 2004, Connors Bros. Income Fund completed its C\$800 million combination transaction with Bumble Bee Seafoods, and in January 2005, BFI Canada Income Fund closed a C\$1.1 billion transaction that combined its business with that of IESI Corporation, a leading non-hazardous waste management company in the United States. In these transformational M&A transactions, the primary objective of the fund is accretion: creating an immediate increase in distributable cash for unitholders. This focus on accretion imposes a certain discipline on the transaction.

To set the stage for a discussion of these transactions, a review of cross-border income securities is helpful.

The Canadian Income Fund Market

The income trust structure is well-accepted in Canadian public markets and has grown considerably in recent years, particularly in the current environment of relatively low interest rates and uncertain equity markets. In 1997, income trusts represented an approximately C\$15 billion industry; now, they represent well over C\$110 billion, based on market capitalization. Investors are clearly seeking out income funds: many of the offerings that have closed in 2005 have been significantly over-subscribed, due largely to a shortage of product, while pricing has tended to be at the low end of the yield range for marketing purposes.

The typical income fund structure involves a business trust that holds equity and debt in a Canadian operating business, producing a stream of steady returns in the form of dividends

and interest, which the trust in turn distributes to its unitholders. The trust is a flow-through vehicle for tax purposes, thereby maximizing distributable cash.

In 2002, private equity sponsors began using the Canadian income trust IPO model to take public US-based businesses. The first of these transactions was completed in May 2002 when Heating Oil Partners Income Fund closed its Canadian initial public offering to fund the acquisition of a US-based residential heating oil distributor. Other US businesses in a variety of industries adapted the Heating Oils model—six additional cross-border income fund IPOs were completed for aggregate proceeds of over C\$1.2 billion.

Income Deposit Securities (IDSs) and Enhanced Income Securities (EISs)

In 2003, Income Deposit Securities (IDSs), or Enhanced Income Securities (EISs), were introduced as a derivation of the income fund structure and as a means to tap into the larger US capital markets. For convenience, we will refer to these as IDSs in this article.

The IDS structure is essentially an income trust structure without the trust. Rather than holding units of a trust, the investor holds the underlying securities—subordinated notes and common shares of a holding company or the operating company—directly. These two securities are “clipped” together to form an IDS.

Holders of IDSs receive interest at a fixed rate on the subordinated notes and discretionary dividends on the common shares to produce a blended yield. The distribution policies of IDS issuers are similar to those of income trusts, REITs and master limited partnerships (MLPs), which distribute a significant portion of their free cash flow. The efficient structuring of the IDS maximizes this distributable cash.

Predictable distributable cash is a key element of these offerings, as they are priced based on a yield relative to expected distributable cash. Completed offerings of IDSs in the United States have been valued at eight to ten times distributable cash and have yields of 10 to 12 percent.

The first IDS offering that was completed was the US\$275 million initial public offering by Volume Services America Holdings, Inc. (now known as Centerplate, Inc.), a catering and sports arena concessions company, in December 2003. After the completion of this offering, at least 20 IDS offerings were filed with the US Securities and Exchange Commission with refinements in the structure and with changes made to address US tax, accounting and regulatory considerations. However, to the date of this writing, only three additional IDS offerings have been completed, four have been converted to offerings of high dividend common shares, and a number have been withdrawn.

The Canadian Version of Income Securities

Canada has its own version of IDSs, initially known as Income Participating Securities (IPSs) or more simply as income securities (ISs). ISs are similar in structure to IDSs, but are better suited to a US company offering only in Canada.

ISs are also particularly attractive to Canadian investors, as these securities are not considered foreign property for Canadian tax purposes. This facilitates investments to be made by individuals through their registered retirement savings plans, and by institutional investors who are subject to limits on their holdings of foreign property.

The regulatory review process for IS offerings in Canada has been less difficult and faster than clearing IDS offerings in the United States, primarily due to the well-established income trust market. At the date of this writing, four IS offerings have been completed and many others are in progress.

The Next Wave in Cross-Border Income Securities

The two transformational M&A transactions referred to above may signal the next wave in cross-border income securities. From the fund's perspective, these transformational M&A transactions are a means to deliver immediate accretion to its unitholders. From the selling private equity sponsor's perspective, these transactions can provide partial liquidity for their investment and an exit strategy in the future for their retained interest.

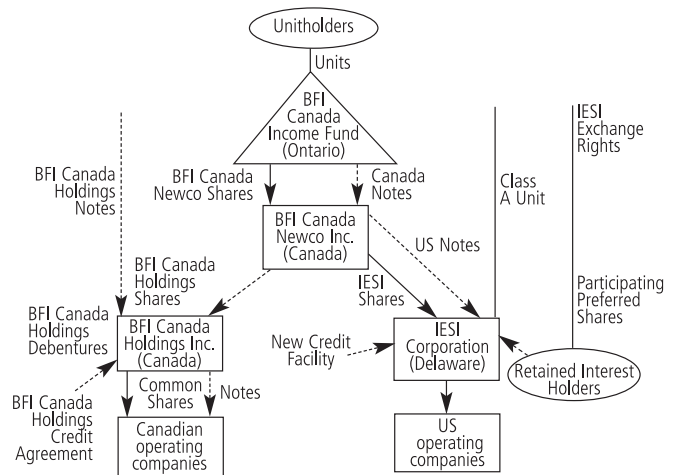
In April 2004, Connors Bros. Income Fund, an established Canadian income trust that owns the largest producer of canned sardines in the world, combined its operations with Bumble Bee Seafoods, a California-based company, to create North America's largest branded seafood company. The transaction was expected to be immediately accretive to unitholders by 12.5 percent. Following the completion of the transaction, the fund held an approximate 68.3 percent interest in the combined business and the sellers held the remaining 31.7 percent interest (the so-called retained interest). This retained

interest is exchangeable into units of the fund.

In January 2005, BFI Canada Income Fund and IESI Corporation, a Texas-based company, completed the combination of their businesses to create one of North America's largest non-hazardous solid waste management companies. The transaction was structured to be immediately accretive to the fund's cash distributions by 12 percent. Post-transaction, the former owners of IESI held an approximately 35.6 percent retained interest in the combined business.

In both of these transactions, the acquired company was substantially larger than the acquiring fund and resulted in a fund with significantly greater market capitalization: from approximately C\$230 million to C\$800 million (post-transaction) in the Connors Bros.–Bumble Bee Seafoods deal, and from approximately C\$680 million to C\$1.5 billion (post-transaction) in the BFI Canada–IESI deal (in each case assuming the exchange of retained interest into units of the fund).

As enticing as these transformational M&A transactions may seem, they are not straightforward and require the coordination of multiple and concurrent transactions that straddle the border—including an acquisition, a trust unit financing, the refinancing of senior credit facilities and a unitholder meeting to approve the transaction. The fund must also pay close attention to its transaction expenses, lest the cost of a broken deal affect the fund's ability to make cash distributions to unitholders.



II. Transformational US Acquisitions: Structure and Financial Models

The Internal Tax Structure

Among the important considerations in developing the internal capital structure in these transactions is the proper mix of debt and equity between the Canadian acquisition cor-

poration (BFI Canada Newco in the example below) and the US target (IESI Corporation in the example below). The post-closing structure for the BFI Canada-IESI transaction can be used as an example, as shown in the following chart.

When BFI Canada Newco receives interest on the subordinated notes issued by IESI (a US corporation) and dividends on the common shares of IESI, both are US-source income. As a result, US withholding tax, at a rate of 10 percent, applies on the interest payments and 5 percent on the dividends.

An essential element of the tax structuring is to ensure that the subordinated notes are considered debt for US federal income tax purposes. If the subordinated notes are determined to be equity, the interest payments would not be deductible for tax purposes. The inability of IESI to deduct the interest on the subordinated notes would increase its US federal taxable income and its US federal tax liability.

In the United States, determining whether an instrument such as the subordinated notes should be treated as debt or equity is a facts-and-circumstances test that takes into consideration a variety of factors (whereas in Canada, a form-over-substance test is applied). Since subordinated notes are issued to a related party, there is heightened scrutiny.

In transactions such as Connors Bros.–Bumble Bee and BFI Canada-IESI, typically a legal opinion is given that analyzes whether the subordinated notes should be treated as debt for US federal income tax purposes. To assist in this analysis and to support the opinion, a number of actions are undertaken. Representation letters are obtained from the issuer and holder of the subordinated notes as to certain factual matters and their intended treatment of the subordinated notes. Additionally, an independent financial adviser is retained to vet the terms of the notes (including the interest rate, maturity date, material provisions relating to the payment of principal and interest, remedies upon events of default and covenant provisions). Among other items, the independent financial adviser determines whether the terms of the subordinated notes are consistent with those of notes issued in arm's-length transactions on market terms, and whether, after reviewing the financial model, the issuer should be able to repay the subordinated notes in accordance with their terms.

New Inversion Legislation

Another tax consideration for these transformational M&A transactions is the inversion legislation that was enacted by the US Congress in late 2004. This legislation is targeted at certain transactions in which a non-US entity acquires substantially all of the assets of a US entity and in which the former equity owners of the acquired US entity receive a certain percentage inter-

est (either 60 percent or 80 percent) in the non-US entity determined without regard to the securities issued in the public offering of the non-US entity to partially fund the acquisition of the US business. Since BFI Canada Income Fund was an existing fund with significant unitholders, the inversion legislation did not apply to the BFI Canada-IESI transaction; however, it could apply in similarly structured transactions. The application of this legislation could have potentially material adverse tax consequences, including, where the 80 percent threshold is met, treating the fund as a US entity for US federal income tax purposes. The result would be that the fund would be subject to US federal income tax and its distributions would be treated as US-source dividends subject to US withholding tax.

The Essential Pieces of the Puzzle: The Inputs to the Financial Model

The financial model is the starting point for these transformational M&A transactions and forecasts whether the acquisition can deliver the required accretion.

The two essential pieces of the financial model are the capital structure (which, as described above, comprises the mix of internal debt and equity between the Canadian acquisition corporation and the US target) and the accretive cash flow generation capabilities of the acquired business.

As the financial model is built, the sources and uses of funds are fed in and accretion is tested. The sources of funds typically consist of proceeds from a subscription receipt offering by the fund (these subscription receipts are automatically exchanged into units of the fund on the closing of the transaction) and borrowings under new Canadian and/or US credit facilities. The uses consist of the repayment of existing credit facilities and expenses associated with the transaction, and can include purchase consideration of the sellers if they are receiving cash in addition to their retained interest.

III. The Transaction Agreement: Driven by the Structure and Financial Models

To ensure that the fund achieves the expected accretion, it requires closing conditions that reflect the terms of the financial model. Having regard to the precedent transactions, the parameters of the financial model are built into the transaction agreement and into the closing conditions. For example, the parties agree to the acceptable range of the size of the subscription receipt offering, the borrowings under the new credit facilities to fund the transaction, and the terms of the repayment of the existing debt (and the associated expenses). If there is substantial deviation from these parameters, the fund can terminate

the transaction agreement without cost (except for its expenses).

A further protection provided to the fund in its undertaking to deliver the agreed-upon accretion to its unitholders is the survival of the representations and warranties. In a typical public company combination transaction, the sellers would generally insist on the representations and warranties expiring on closing; however, in transformational M&A transactions, the fund is concerned to sustain breaches of the representations and warranties without recourse, as these could have a substantial impact on cash distributions. Accordingly, in these transactions the representations and warranties survive for a specified period of time, and the fund can recover from the former owners of the acquired business for any breaches thereof.

The transaction agreement also provides the fund with a fiduciary out in the event that a superior proposal is made for the fund and the other party does not match the offer or the fund still considers that the other proposal is superior. In such an event, the fund would be required to pay a break fee, and in some cases, be subject to a sharing of the transaction expenses incurred up to that point. In these transformational M&A transactions, the break fee is payable in narrower circumstances than in a typical M&A transaction because of the fund's need to manage payments that could reduce distributable cash. For example, if the unitholders do not approve the transaction, no break fee is payable.

IV. The Financing: Subscription Receipt Offering and Senior Debt Refinancing

Subscription Receipt Offering

In conjunction with the acquisition and related funding requirements, the fund conducts a subscription receipt offering in Canada within the parameters set out in the transaction agreement. The size of the offering is informed by (a) the amounts needed to pay off existing debt and transaction expenses, (b) whether the existing owners of the acquired business will be bought out, (c) the availability of borrowings under the new credit facilities and (d) the capacity of the Canadian capital markets to absorb the offering.

The reason for a subscription receipt offering rather than a unit offering is to provide a mechanism for the fund to return the offering proceeds to investors if the M&A transaction does not close. The subscription receipt offering closes in advance of the M&A transaction and the proceeds are held in escrow. Upon the closing of the M&A transaction and the satisfaction of the conditions thereunder, the subscription receipts are automatically exchanged for trust units (without payment of any additional consideration). The subscription receipt hold-

ers also receive an amount equal to the per-unit distribution that they would have received had they owned units rather than subscription receipts from the time of the closing of the offering. If the M&A transaction fails to close by a specified date, or if the transaction agreement is terminated at any earlier time, the fund returns the issue price plus accrued interest to the subscription receipt holders.

The mechanism of a subscription receipt offering eliminates significant execution risk for the fund. However, this insurance comes at a cost: not only does the fund incur the expenses of the offering (without certainty that the cash raised is needed), but in the recently closed deals, it would have had to also pay one half of the underwriters' commission, regardless of whether the M&A transaction closed.

One interesting issue that is raised in the context of subscription receipt offerings conducted in conjunction with transformational M&A transactions is whether the Canadian securities regulators will impose liability on the retained interest holders for misrepresentations in the prospectus relating to the acquired business. Promoter liability under applicable securities laws may be triggered if it is shown, for example, that there has been a substantial reorganization of the business. Whether this test should be applied at the fund level or the operating entity level has been a source of debate with Canadian securities regulators. As the fund cannot conduct any business (for tax reasons, it is only an investment vehicle), some believe that it is appropriate to apply the test at the operating company level. If the Canadian and US businesses being combined are held, and will continue to be held post-closing, in different holding companies, it is less likely that the transaction would be characterized as a substantial reorganization of the business. Applying the test at the fund level could lead to a different result.

Another consideration in determining whether promoter liability will be imposed is whether the former owners of the acquired business are receiving any of the offering proceeds. To the extent that there is a misrepresentation in the prospectus relating to the acquired business, investors and the fund may have recourse against the former owners who received part of the proceeds. Typically, this coverage is provided contractually through the representations and warranties in the transaction agreement, rather than through the application of the promoter liability provisions of securities laws. This outcome is consistent with true arm's-length M&A transactions and appears to be the view of Canadian regulators.

Senior Debt Refinancing

The capital structure of these transactions and the fund's

commitment to make cash distributions also affects the terms of any new credit facilities being entered into in conjunction with the M&A transaction. Senior lenders have to be cognizant of and make provision for cash flowing through and out of the structure more freely than in a typical senior debt facility. The acquired company must be permitted to make monthly distributions on its equity, such that the fund can flow this cash to its unitholders. To provide some comfort to the senior lenders in this context, protections can be built into the facility, such as restricting cash distributions to those that are in the ordinary course consistent with accepted market practice for subsidiaries of Canadian income trusts, permitting cash distributions only to the extent of available free cash (as defined in the facility) and/or requiring that certain leverage or coverage ratios are met.

V. Retained Interest

These transactions also involve the negotiation of the corporate governance rights granted to the retained interest holders.

The fund may take the position that the retained interest holders have adequate rights through their direct or indirect equity stake in the combined business and should not be granted additional corporate governance rights; however, the retained interest holders may expect to have post-transaction governance rights comparable to those they formerly had in order to protect their significant interest in the combined business.

If the retained interest holders maintain an equity stake in the acquired business (or another trust subsidiary) rather than directly at the fund level, they will, at a minimum, want to ensure that their economic and voting rights are protected to be equivalent to those they would have had as unitholders. Beyond that, the grant of any additional corporate governance rights is the subject of negotiation and will be dependent on numerous factors such as (a) the retained interest holders' proportionate stake in the fund going forward, (b) whether the retained interest is represented principally by one or two large investors or is relatively dispersed and (c) the size of the acquired business relative to the fund.

VI. Conclusion

The Connors Bros.–Bumble Bee and BFI Canada–IESI transactions broke new ground for Canadian income funds. Given the opportunities that these transactions present to the fund and selling private equity sponsors—and as M&A activity regains its vigor—we can expect to see more of these transformational M&A transactions.

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Alexandra A. Kau, Torys LLP

Tel: (212) 880-6024

Fax: (212) 682-0200

E-mail: akau@torys.ca

Alexandra Kau's practice includes a broad range of transactions with an emphasis on cross-border mergers and acquisitions (public and private) and corporate finance (both debt and equity offerings). Her income securities experience includes acting for DavCo Restaurants in its proposed initial public offering of Enhanced Income Securities in the United States, and on a cross-border basis, acting for BFI Canada in its merger with IESI.

**Philip J. Brown, *Torys LLP*****Tel: (416) 865-8238****Fax: (416) 865-7380****E-mail: philbrown@torys.com**

Philip Brown's practice focuses on investment banking, public financing, income trusts, M&A and innovative corporate finance transactions. Phil's extensive income fund experience includes representing both underwriters and issuers on many domestic and cross-border income securities transactions, including, most recently, acting for BFI in its merger with IESI.

**Richard G. Willoughby, *Torys LLP*****Tel: (212) 880-6234****Fax: (212) 682-0200****E-mail: rwilloughby@torys.com**

Richard Willoughby's practice includes advising on mergers and acquisitions, including private acquisitions and divestitures (often in an auction context), leveraged buyout transactions, takeover bids and joint ventures. He also represents issuers and underwriters in public offerings and private placements of equity, debt and derivative securities, and venture capital financings. Richard leads Torys' US initiatives in cross-border income funds and IDSs.